

Strategic Assessment of the Needs of Small and Medium-sized Enterprises in the Russian Far East

**Prepared by
CARANA Corporation
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Table of Contents

Acronyms	iii
Executive Summary	v
I. Introduction	1
A. The Role of SMEs in Market Economies	1
B. USAID Support for SME Development.....	1
C. Purpose of the Study	2
D. Methodology	2
E. Organization of the Report	3
F. Acknowledgements	3
II. The Evolution of SMEs in Russia: A Historical Perspective	5
A. The Soviet Experience	5
B. SMEs in the Post-Soviet Era	5
C. The Putin Reform Push	5
D. The Size and Economic Importance of SMEs in Russia.....	6
III. Findings: Donor Assistance for SME Development	12
A. USAID Programs	12
1. Improving Business Skills	12
2. Expanding Credit Availability.....	14
3. Improving the Policy and Regulatory Environment for SMEs	14
4. Exploiting Opportunities in Selected Sectors.....	15
B. The Eurasia Foundation	16
C. Other Donors	16
IV. Findings: Key Factors Influencing SME Growth in the RFE	20
A. The Russian Macroeconomic Environment	20
B. Geography of the RFE	22
C. The Policy and Regulatory Environment	24
D. Credit Availability	26
E. Business Skills	31
F. Physical Infrastructure.....	32
G. Influence of the Business Community.....	34
V. Findings: SME Potential within Selected Industries	36
A. Timber Processing	36
B. Non-timber Forest Products	37
C. Oil and Gas.....	38
D. Fisheries	39
E. Ecotourism.....	40
F. Other Industries	41

VI.	Conclusions and Recommendations	42
A.	General Conclusions and Recommendations	42
1.	General Conclusions	42
2.	General Recommendations	43
B.	Conclusions and Recommendations on Specific Strategies.....	43
1.	Developing Business Skills	44
2.	Improving Access to Credit	47
3.	Improving Government Policy and Regulation	48
4.	Exploiting Opportunities in Key Sectors and Geographic Areas ..	49
5.	Priorities Among Strategies	50

Appendices

1. Scope of Work
2. List of Interviews
3. Interview Protocols
4. Assessment Team Members
5. Data Problems
6. Other Industries with Potential for SMEs
7. The Environment for SMEs in Selected Cities in the RFE

Acronyms

ACDI/VOCA	formerly the Agricultural Cooperative Development Institute and Volunteers in Cooperation for America, now simply ACDI/VOCA
AmCham	American Chamber of Commerce
AMM	Academy of Management and Market (Home of the Morozov Project)
ARC	American Russian Center of the University of Alaska/Anchorage
ARCs	The BSIs administered by ARC
BDI	USAID's Office of Business Development and Investment
BISNIS	Business Information Service for Newly Independent States
BSI	Business support institution
BSN	Business Support Network
CA	Cooperative Agreement
CCI-PEP	Center for Citizen Initiative – Productivity Enhancement Program
CDC	Citizens Democracy Corps
CEFIR	Center for Economic and Financial Research
CIPE	Center for International Private Enterprise
EBRD	European Bank for Reconstruction and Development
EBS	Entrepreneurial Business Services Program
EU	European Union
FESTU	Far Eastern State Technical University
FESU	Far Eastern State University
FOREST	Forest Resources and Technology Project
FRAEC	The Foundation for Russian American Economic Cooperation
FSVC	Financial Services Volunteer Corps
G-7	The Group of Seven Countries
GDP	Gross Domestic Product
GSU	Georgia State University
HIID	Harvard Institute for International Development
IAITO	International Association of Independent Tour Operators
IBS	Integrated Business Services Project
IE	Individual Entrepreneurs
IESC	International Executive Service Corps
INCAE	Instituto Centroamericano de Administracion de Empresas (the Central American Institute for Business Administration)
IPSSA	Institute for Private Sector Development and Socio-Economic Analysis
IREX	International Research and Exchanges Board
IRIS	Center for International Reform and the Informal Sector
ISC	Institute for Sustainable Communities
JA	Junior Achievement
KMB	Small Business Credit Bank
MBA	Masters in Business Administration (program or degree)
MFI	Micro-Finance Institution
MRC	Morozov Regional Center (a BSI in the Morozov program)
NBFI	Non-Bank Financial Institution
NGO	Non-governmental organization

NIS	Newly Independent States
NTFP	Non-timber forest products
RABTC	Russian-American Business Training Center (ARC)
RFE	Russian Far East
RII	USAID's Regional Investment Initiative
ROLL	Replication of Lessons Learned Project
RSBF	Russian Small Business Fund of the EBRD
RVF	Regional Venture Fund
SABIT	Special American Business Internship Training Program
SEE	Small Enterprise Entity
SE	Small Entrepreneurs
SETT	Strengthening Economic Think Tanks (a USAID/Russia program)
SME	Small and medium-sized enterprises
SO	Strategic objective of USAID
SWP	Secondary Wood Processing
TA	Technical assistance
TACIS	The European Union's economic assistance agency
TUSRIF	The United States – Russia Investment Fund
UAA	University of Alaska at Anchorage
USAID	U.S. Agency for International Development
WWF	World Wildlife Fund

Executive Summary

USAID's strategy in Russia has sought to assist that country's transition from a centrally-controlled economy under a totalitarian government to a market economy within the context a democratic, pluralistic society. A key component in that strategy has been support for the development of small and medium-sized enterprises (SMEs), which would contribute to both of those (economic and political) objectives. To implement that strategy, USAID has financed a variety of programs to improve the policy and regulatory environment in which SMEs operate, to enhance business skills and to develop systems for the provision of credit to entrepreneurs.

This assessment reviews the current state of development of and constraints to SMEs in the Russian Far East (RFE) with a view to providing suggestions to USAID about its future strategy. The study reviews the current level of SME development, programs in effect to accelerate SME growth, constraints to SME development, and SME prospects in five sectors identified by USAID. The study then draws a number of conclusions and makes recommendations about future USAID strategy.

This assessment was conducted in Russia and in the U.S. during the period October 2002 to January 2003 by a six-member CARANA Corporation team. The assessment team reviewed pertinent documents and spent four weeks in the field visiting seven cities of the RFE. During that period, it interviewed more than 200 people representing more than 125 organizations.

Growth of SMEs

During the last 15 years, despite enormous social and economic dislocation and serious institutional impediments, SMEs have emerged to become a significant part of the Russian economy. Recent data suggest that there are approximately 5.5 million SMEs. SMEs employ almost 45% of the labor force and generate about 40% of annual sales. Russia has an estimated 37 SMEs per 1000 inhabitants, compared to 45 SMEs per 1000 inhabitants in the EU. Despite the special problems that confront the RFE, the best available data suggest that SMEs in that sparsely populated region have developed at a slightly faster rate than in the rest of Russia. With a population estimated at seven million, the RFE has approximately 275,000 SMEs, or 39 per 1000 inhabitants. (See Section II, pp. 5-12.)

Some of Russia's SMEs are privatized businesses that existed during the Soviet era, although often in a very different form. Most, however, did not exist a dozen years ago. When one considers the obstacles -- the absence of business skills and experience at the end of the Soviet era, government policies and regulations that created obstacles to business, the lack of institutions providing credit, the financial crisis of 1998 and a host of other factors -- the growth of SMEs in Russia is quite remarkable.

Constraints to SME Development

The assessment identified seven factors that influenced the growth of SMEs in the RFE. Findings about these constraints included the following:

- ***The Macroeconomic Environment.*** The macroeconomic environments in Russia and in the RFE over the past few years have been favorable for SME development. Thanks in considerable part to favorable prices for its export commodities and the devaluation following the 1998 financial crisis, the Russian economy has been growing rapidly, with GDP growth for the 2000-2002 period averaging over six percent. Economic growth in the RFE has largely kept pace with the rest of Russia. The resulting rise in discretionary income has increased demand for many consumer goods, benefiting the retail trade and service industries, where SMEs are major actors. Concerns about the Russian economy include its dependence on high natural resource prices, accentuated income disparities of the population, and anemic foreign investment in this region. (See Section IV.A, pp. 20-22.)
- ***Geography of the RFE.*** The geography of the RFE has a profound impact on the nature of its economic development. The region is blessed with considerable natural resources, including timber and non-timber forest products, minerals, oil and gas, fish, and sites of beauty and interest that have tourism potential. (The prospects for SME growth in selected sectors are discussed in Section V.) With its vast size (twice that of the U.S. 48 contiguous states) and small population (barely seven million), market size and transportation costs are obviously key factors for many industries. (The Trans-Baikal region, part of which the assessment team visited, contributes another 3.5 million people.) The considerable distance between RFE population centers and between those centers and other parts of Russia raises transportation costs and strongly impacts the profitability of SMEs in different locations. While the larger Russian markets are far away, China, Korea and Japan are close to the population centers in the southern parts of the RFE. The trade with these areas is primarily natural resource based (e.g., timber and fish) and conducted by large firms. SMEs dominate in the cross-border “shuttle trade” with China in textiles, food products and other consumables. (See Section IV.B, pp. 22-24.)
- ***The Policy and Regulatory Environment.*** The policy and regulatory environment has improved somewhat, but remain one of the most significant constraints on SME growth. There is little evidence that the reforms introduced by the Putin Government have yet had a positive impact on SMEs in the RFE. (See Section IV.C, pp 24-26.)
- ***Credit Availability.*** Thanks to the efforts of the EBRD (with USAID participation) and other initiatives, some banks have begun to lend to SMEs. Other donor initiatives, including microfinance and leasing programs have also had a positive effect. Nevertheless, the lack of credit remains a very serious obstacle to the establishment and growth of SMEs. Most of the development achieved to date is financed either directly by the entrepreneur or through informal channels. (See Section IV.D, pp. 26-31.)

- **Business Skills.** Thanks in part to USAID programs, the RFE enjoys an infrastructure of business support institutions (BSIs) that offer business training and consulting. The assessment team's interviewees revealed little indication of training or consulting demand that could not be met through those existing institutions. Not surprisingly, larger urban centers are better served than smaller, more remote areas. Although many of the training organizations are small and function at a modest level, with the exception of the ARC centers they seem to be financially self-sustaining. These institutions will improve over time as their trainers and consultants gain practical experience. (See Section IV.E, pp. 31-32.)
- **Physical Infrastructure.** The RFE's physical infrastructure (airports, railways, roads, ports, hotels, commercial space) is poor in comparison to most other parts of Russia and is a constraint to SME development. Because of the vast distances and relatively sparse population, the cost per capita for investment and maintenance of infrastructure in the region are high, as are operating costs for all forms of transportation services. Electricity rates are also higher than in many other parts of the country. These factors make it more difficult for businesses in the RFE to compete with firms in other regions of the Russia. (See Section IV.F, pp 32-34.)
- **Influence of the Business Community.** With the exception of Khabarovsk and possibly Vladivostok, the team found few broad-based business associations, think tanks and university programs influential in the business community in the RFE. Dialogue on business issues tends to be dominated by government officials, oligarchs, firms involved in natural resource exploitation and other large firms that grew up in the Soviet era. (See Section IV.G, pp. 34-35.)

The Potential for SME Growth in Selected Sectors

The assessment team reviewed the potential for SME growth in five sectors: timber processing, non-timber forest products (NTFPs), oil and gas, fisheries, and ecotourism. Of these, the team believes that potential for SMEs is highest in timber, NTFPs and ecotourism.

- **Timber.** The RFE has enormous timber resources. These resources are being commercially exploited, but much of the product is exported as logs. There is considerable potential for secondary wood processing. USAID's Forest Resources and Technology Project (FOREST) project is assisting SMEs to develop this potential. (See Section V.A, pp36-37.)
- **NTFPs.** The RFE's abundant forests contain a wide variety of non-timber products that can be commercially exploited. The potential for SME growth in this sector is considerable. USAID's FOREST project is providing assistance through associations of small producers to improve technology and marketing. (See Section V.B, pp. 37-38.)
- **Oil and Gas.** Large-scale investment in oil and gas production is currently underway on Sakhalin Island and in parts of Primorski Krai. These investments are already having

major impacts on local and regional economies, but SMEs are not likely to participate directly as suppliers to the international consortium of firms implementing those investments. Those firms are putting in place a vertically integrated operation that will not be dependent on local firms. However, SMEs will benefit indirectly from the greatly enhanced disposable income likely to result in those regions. (See Section V.C, pp. 38-39.)

- **Fishing.** The RFE's fishing industry is centered primarily in Primorski Krai; Kamchatskaya Oblast; Sakhalinskaya Oblast, and Khabarovski Krai. The industry is dominated by large firms. Entry into the industry is difficult, due in part to the sizable upfront investment in equipment that is required to be competitive. Thus, the prospects for SME growth within this sector are not favorable. (See Section V.D, pp. 39-40.)
- **Ecotourism.** Although the RFE boasts many sites that are of potential interest to tourists with an interest in ecological assets, this potential is largely undeveloped. Ecotourism enjoys the advantage that, compared to other forms of tourism, the number of clients that one seeks to attract is less; they are often willing to require less amenities and to be willing to endure some discomfort. Nevertheless, the exploitation of the RFE's potential in this sector will require improvement in transportation systems to and within the region, the development of hotels and restaurants at or near key sites, and (at least in some cases) public sector investment in roads and other infrastructure. (See Section V.F, pp. 40-41.)

B. General Conclusions and Recommendations (See Section VI.A, pp. 42-43.)

General Conclusions

- The rapid growth of the SME sector in the RFE suggests that Russian entrepreneurs, although lacking in business experience, are adept at overcoming the many obstacles they confront.
- Increased competition among SMEs is creating predictable market responses: higher quality, more variety, lower prices and better service.
- The increased competition in those sectors where SMEs are concentrated (e.g., retail trade, services) may push future SME investment toward new industries.
- The activities of USAID and other donors have spawned business support services that have contributed to the growth of the SME sector.
- Currently, the most serious constraints to SME development (that are amenable to change) are the lack of credit and the policy and regulatory environment. Easing these constraints would allow much greater expansion of SMEs over the near term.
- There are significant geographic disparities within the RFE in the availability of SME support services such as credit and training.
- Available data suggest that women are not equally represented in SME management.

General Recommendations

- Continue to support SME development in the RFE.
- Focus interventions on improving access to credit and, where opportunities present themselves, on improving the policy and regulatory environment.

- To the extent consistent with USAID’s geographic priorities, extend services to relatively underserved communities.

Conclusions and Recommendations on Alternative USAID Strategies (See Section VI.B, pp. 43-50)

1. Developing Business Skills

Conclusions

- USAID has played a very positive role in the development of the region’s business skills training institutions.
- Although there are disparities within the region, business training is available and generally adequate to meet current needs of SMEs.
- USAID’s resources for developing business skills in the RFE are currently allocated largely to the ARC program – a high quality program that should be operating independently with a minimum of external financing.
- While many Russian business training institutions would benefit from continued USAID assistance, the return on such investments is declining.
- Junior Achievement offers a cost-effective method of preparing the next generation of Russians to understand the workings of and participate in a market economy.
- There is limited availability of high-level business training, research on business issues or intellectual leadership within the private sector.

Recommendations

- Limit future USAID investment in basic level business education.
- Shifting resources from business training to other strategic areas implies a need for USAID to end financing for the ARC program.
- Should the Mission decide to continue assistance for basic business skills development, focus investment on cost-effective methods to upgrade training and consulting of existing Russian BSIs.
- Continue support to Junior Achievement.
- Consider the development of a U.S.-style university-based business school in the RFE.

2. Improving Access to Credit

Conclusions

- Access to affordable credit remains one of the most serious obstacles to SME growth in the RFE.
- Donor programs that work intensively with selected banks, providing them with credit and technical assistance, are an effective approach to expand lending to SME clients.
- Donor-assisted MFI programs are filling an important credit gap, providing resources to viable firms that lack access to bank credit.

- Venture capital is generally not available in the RFE, but could contribute to SME development.

Recommendations

- Support the expansion of lending to SMEs by commercial banks.
- Support the development of microfinance institutions in underserved RFE markets.
- Encourage the availability of leasing programs in underserved areas.
- Consider sponsoring the creation of a venture capital fund focused on SMEs in the RFE.

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3. *Improving Government Policy and Regulation*

Conclusions

- Problems in the policy and regulatory environment remain a primary obstacle to SME development in the RFE.
- SME business associations are typically localized, not well organized and have limited influence on policy or regulation.
- USAID's current strategy to improve the policy and regulatory environment (aimed at policy reform at the regional level and implemented through the Mission's grant to CIPE under the SME Policy Reform project) is based on a realistic assessment of what is possible in Russia and has significant potential to aid SME development.
- Provision of relevant information and analyses has a very positive impact.

Recommendations

- Continue (and possibly expand) support of existing programs that help to inform the decision-making process and the public with respect to SME issues.
- Continue to strengthen business associations through CIPE and/or through interchanges, networking, partnering and mentoring Russian business associations with U.S. associations.

4. *Exploiting Opportunities in Key Sectors or Geographic Areas*

Conclusions

- The most promising sectors appear to be timber processing and non-timber forest products -- the sectors in which USAID is already involved through the FOREST project.
- The opportunities for SME growth in the oil and gas and fisheries industries are not promising.
- Ecotourism resources are extensive and might be commercially exploited but need to be protected and managed by the public sector.
- Disparities are apparent in the support available to SMEs in the seven different geographic areas visited.
- Other sectors do not warrant specific USAID programs. (See Appendix 6.)

Recommendations

- Continue promoting the wood processing and non-timber forest product industries through the FOREST project.

- Consider a pre-investment study to ascertain the feasibility of developing the potential for ecotourism in the RFE and surrounding areas. Ecotourism development will require a level of open and transparent collaboration between various government agencies and between government and the private sector that may be difficult to achieve.

5. *Priorities Among Strategies*

Recognizing that this report has suggested a number of initiatives and that the Mission, for budgetary reasons, may need to make difficult choices, the assessment team offers its view of what might be first priority and second priority activities.

First priority activities:

- ***Credit.*** The assessment team would give highest priority to efforts to expand the geographic coverage of microfinance programs and to expand bank lending to SMEs.
- ***Policy and Regulatory Reform.*** As a constraint, government policy and regulation may be as important as credit. The Mission should continue to focus on limited but well-designed activities to educate and influence the policy and regulatory environment.

Second priority activities:

- ***Improving Business Skills.*** The assessment team views additional USAID investment in this area as somewhat less critical. A special exception should be made for consideration of the Junior Achievement program and for the idea of a graduate business school. Each would result in substantial long-term benefits in terms of the kind of democratic, market-based society to which USAID is trying to contribute. The latter would lead to the development of large and small businesses, a community of business researchers and consultants, and to strengthening business ethics.
- ***Sector-specific Programs.*** Efforts under the FOREST project seem well-targeted to exploit and explore growth prospects. Ecotourism also has potential, but exploitation of that potential will require considerable time and investment.

I. Introduction

A. The Role of SMEs in Market Economies

Why do small and medium-sized enterprises (SMEs) matter in Russia? While the answer may seem obvious, it is worthwhile to step back for a moment to assess the broader importance of SMEs:

- **SMEs drive economic growth.** In most market economies, small and medium-sized enterprises are the most dynamic and the largest contributors to economic growth. While large companies sometimes enjoy economies of scale, they rarely have the flexibility to respond rapidly to shifting market conditions. As a result, SMEs as a group are typically more important economically than their larger brethren. In the European Union, for example, SMEs account for 57% of total GDP and nearly two-thirds of total employment.
- **SMEs play a key role in the development of a middle class.** Part of the legacy of the Soviet command economy is that control over the largest, most valuable companies in the country passed from the old Soviet elite to a new Russian elite. Many of these large companies, in fact, have changed little and offer few opportunities for earnings growth and career advancement to the vast majority of Russians. SMEs offer Russians one of the principle paths to participation in the middle class.
- **SMEs are central to the development of political pluralism.** A corollary of the development of a middle class is the concomitant evolution of political pluralism. Small business owners typically become active members in their political environment – lessening the dominance of the moneyed elite and expanding participation in the political process.

These potential benefits from the development of SMEs are becoming a reality in Russia. During this period (the past 15 years) of massive social and economic dislocation, SMEs have emerged – far more than has been widely believed – to play a central role in abetting the transition to a market economy and a pluralistic, democratic society.

C. USAID Support for SME Development

USAID/Russia's program has been focused on assisting Russia's transition from a centrally controlled economy to a market economy and to the development of a democratic, pluralistic society. Support for the development of small and medium-sized enterprises has been seen as a key component in the Mission's strategy to achieve those objectives. The Mission has assisted in the development of key national institutions and policies and in establishing institutions to support the development of SMEs in many parts of the country. (Section III.A below provides a summary of USAID assistance in these areas.)

C. Purpose of this Study

USAID/Russia's scope of work for this study (See Appendix 1.) asks the contractor to assess the constraints to the development of SMEs in the Russian Far East (RFE), to consider the potential impact of alternative USAID strategies to overcome those obstacles, and to recommend a strategic approach to the Mission. To achieve these objectives the contractor was expected to:

- Assess the environment for SMEs
- Identify factors that constrain the growth of SMEs
- Review USAID and other donor programs affecting SMEs
- Review the prospects for SME development in five selected sectors
- Recommend how USAID might best strengthen SMEs in the future

The reader should note that region studied for this report does not correspond directly to the RFE. The team did not visit all areas of the RFE, and (at USAID's request) it included Ulan-Ude and Chita, areas not traditionally considered part of the RFE. For the purposes of this report, the term RFE is intended to include those areas.

D. Methodology

Pursuant to the scope of work, the CARANA Corporation recruited a team of six development experts, each with SME development experience. The team included three Russians and three Americans. All team members had considerable prior experience in Russia, and several have had prior experience in the RFE. (See Appendix 4.)

The team initiated its work with a review of pertinent background documents. To facilitate this activity, USAID/Russia provided electronic copies of studies related to business development in Russia, USAID strategy papers, previous evaluations, and documents describing many on-going and past SME development projects.

The assessment team carried out its work in the field during the four-week period, October 26 to November 23. The team utilized this time as follows:

- *Week 1 - Moscow.* The team met with USAID/Russia staff to discuss the proposed study, the Mission's objectives and the team's work plan. The team also met with a large number of Moscow-based organizations working in the RFE. The team arranged the logistics for visits to seven cities in the RFE and set up many of the appointments that it would conduct in the subsequent weeks. The team also developed interview protocols (see Appendix 3) for planned interviews.
- *Weeks 2 and 3. The Russian Far East.* The team visited seven cities in the RFE: Blagoveshchensk, Chita, Khabarovsk, Ulan-Ude, Vladivostok, Yakutsk and Yuzhno-Sakhalinsk. To cover this geographic area, the team split into three two-member mini-teams. Each team met with businesses, government officials, business association leaders, banks and non-bank financial institutions, business training and consulting organizations and other relevant groups and individuals

involved in SME development. Although team members visited only capital cities in the seven provinces visited, they collected information more generally about those territories. In total, team members conducted interviews with more than 200 people representing more than 125 organizations (See Appendix 2.)

- *Week 4 – Moscow.* The mini-teams reunited in Moscow to discuss the results of their respective trips and interviews and to formulate a preliminary set of findings, conclusions and recommendations. These were presented to USAID orally on November 22. Mission staff provided valuable feedback and guidance on the preparation of the team's report.

Team members returned to their respective homes to draft this report. The draft report was submitted to the Mission electronically on December 17. Mission comments were provided on January 16, 2003. The team considered the Mission's comments and submitted the final report in January 2003.

E. Organization of this Report

This report is divided into six sections, including this one.

- Section II provides a brief summary of the post-Soviet history of SMEs in Russia and assesses the relative importance of the sector to the Russian economy.
- Section III provides a brief overview of donor assistance affecting SME development in the RFE.
- Section IV assesses nine factors that influence SME growth in the RFE.
- Section V reviews the potential for SME growth in five specific sectors.
- Section VI presents the team's conclusions and recommendations to USAID.

Seven appendices provide background material, including (1) a copy of the project's scope of work, (2) a list of persons and organizations interviewed as part of the assessment, (3) a copy of the team's interview protocols, (4) biographies of team members, (5) a brief discussion of problems associated with data on Russian SMEs; (6) a discussion of sectors other than those discussed in Section V in which there may be growth potential for SMEs, and (7) a description of the environment for SMEs in selected cities.

F. Acknowledgements

The team wishes to thank USAID/Russia for support it provided throughout the assessment process. Mission staff emailed electronic copies of key documents several weeks before the fieldwork began. Later, they provided lists of key people in many of the cities that the team planned to visit. They briefed the team on the background and key issues for USAID, and they responded to the team's oral briefing with corrections and helpful suggestions. The team was particularly pleased to have a member of the Mission staff, Ms. Julia Schevchenko, as an observer in Vladivostok and Yuzhno-Sakhalinsk.

The team also wishes to thank the scores of people in the RFE and in Moscow who met with the team as it did its fieldwork. These individuals were extremely generous with their time and ideas.

Any errors or omissions in this report are entirely the responsibility of the assessment team.

II. The Evolution of SMEs in Russia: A Historical Perspective

A. The Soviet Experience

It seems strange that only fifteen years ago there was almost no private enterprise in Russia. Even the notion of private enterprise was almost inconceivable to many Russians, as market-driven, for-profit business was anathema to the fundamental principles of the Soviet command economy. There was virtually no scope for enterprising individuals to start a small business. Indeed, to embark on such a course at that time would have been alien to the Soviet mentality, probably dangerous and, with no legal structure or supporting institutions, extremely difficult to implement. That there are now several million small businesses operating in Russia is truly remarkable. Today, despite numerous constraints that are holdovers from the Soviet era, the SME sector is vibrant and growing, reflecting the capacity of both the Russian people and of the market system to empower and to unleash their motivation and potential.

Liberalization of the economy began in the late 1980s through Mikhail Gorbachev's *perestroika* movement, but early efforts to promote non-state economic activity yielded mixed results – a reflection of the sheer enormity of the task of unshackling an economy that had been a stranger to private enterprise for seven decades.

B. SMEs in the Early Post-Soviet Era

Following the collapse of the Soviet system, mass privatizations of state enterprises – both large and small – resulted in a transfer of assets from the state to, more often than not, the managers of enterprises. Almost overnight, privatization created an army of small businesspeople who, with their employees, controlled their own enterprises.

Small businesses quickly found that being freed from state ownership did not mean that they were independent of the stifling post-Soviet approach toward regulation. Indeed, the SMEs in Russia that survived the chaos of the post-Soviet transition also had to overcome considerable government interference and mismanagement. Newly privatized firms found that gaining control over an asset was much easier than running a business or earning an acceptable return on investment.

During this early transition period the Yeltsin Government laudably paved the way for sustainable democracy in Russia. However, it did little to implement a wide range of desperately needed reforms to unlock the private sector.

C. The Putin Reform Push

It was not until Vladimir Putin took office that the Russian economy – including, crucially, SMEs – began to receive the reformist focus required to improve the business environment in Russia. Russian legislation focused on improving the operating environment for SMEs includes the following:

- The “Law on Standardization” enshrined a range of business and operating standards into law so as to reduce the discretionary regulatory power of government bodies over business;
- The “Law on Reducing the Number of Licensed Activities” reduced the number of activities required special licensing from 2,000 to roughly 120. Only through amendments to federal legislation can new licensing requirements be imposed on SMEs. This is a marked improvement from the previous regime in which additional licenses could be imposed on an almost *ad hoc* basis;
- Modifications to the tax law gave SMEs the choice of paying either 20% of net income (compared with a rate of 24% for other enterprises), or 8% of revenue;
- The “Code of General Principles of the Conduct of State Servants,” signed into law in August 2002, specified principles of fair behavior and judgment for civil servants, thus serving to limit the arbitrary and selective nature of enforcement of legislation;
- The “Law on Protecting Businesses When Conducting Inspections” prohibits regional and federal inspection bodies from abusing businesses when they conduct inspections and gives businesses the right to sue authorities for abuse;
- The “Law on State Registration,” passed in August 2001, simplified procedures for registering a company in Russia, in part by establishing a time limit of five days during which authorities must either register a company, or provide justification for refusing to do so; and
- A draft law on technical certification, which aims to streamline the checks on businesses that government bodies can undertake, introduces the rule of “one standard, one regulator;” this law was approved in first reading by the Duma in June, but has yet to be passed in later readings.

While these legislative initiatives are highly encouraging, it remains to be seen whether the implementation of these reforms will be held up by entrenched interests (including the bureaucracy), particularly at the regional and local levels of government. In this regard, the initial findings of a Center for Economic and Financial Research (CEFIR) project designed to assess implementation of the new deregulation laws were not encouraging. The study found that “Existing practices in the areas of registration, inspections, licensing, and certification are *very far* from the benchmarks established in the new legislation.” Although these findings are a cause for concern, it should be remembered that much of the relevant new legislation has only very recently (January 2002) – or not yet (some laws are slated for implementation in January 2003) – taken effect. Clearly, this situation warrants careful monitoring – a task that CEFIR is planning to carry out with USAID assistance. Progress in implementing reforms will be critical to the continued growth and prosperity of the SME sector and to the Russian economy.

D. The Size and Economic Importance of SMEs in Russia

To assess the size and importance of Russia’s SMEs, one should appropriately begin with a definition of the terms “small enterprise” and “medium-sized enterprise.” This seemingly simple exercise is, in fact, plagued with difficulties. First, there are a number of definitional issues. Russian legislation (Federal Law No. 88-FZ of June 14, 1995, “On

State Support of Small Entrepreneurship in the Russian Federation”) defines three distinct types of small enterprise entities (SEEs):

- Individual entrepreneurs (IEs) without formal legal status;
- Farm enterprises (FE);
- Legally registered small enterprises (SEs), which include:
 - Firms in which Government controls less than 25% of total shares and large companies control less than 25% of total shares;
 - Firms in which the number of workers does not exceed:
 - 100, for industrial production, construction and transport companies
 - 60, for agriculture and science-related companies
 - 30, for retailing and consumer services companies
 - 50, for all other sectors

These definitions vary from those utilized in OECD countries, making comparisons difficult. More importantly, the Russian legislation does not define a category of “medium-sized enterprises.” In effect, that category does not exist, and enterprises that would be considered “medium-sized” in OECD countries are grouped with large firms.

Second, there are serious measurement issues. Goskomstat and other Russian Government agencies provide information for only one of the three categories of small firms: registered small enterprises. Thus, Russian measures of SMEs have excluded individual enterprises, farm enterprises and medium-sized enterprises. Not surprisingly, the resulting data on the size and importance of Russian SMEs have made them look very anemic -- less than a quarter the size of those in the EU (see Table 1 below). However, the June 2002 publication of the Russian SME Observatory Report, developed by the Russian SME Resource Center with funding from TACIS, significantly upgraded the knowledge base on SMEs in Russia. The SME Observatory Report differed from previous studies of SMEs in Russia, employing a broad definition of SMEs that is similar to that used in most Western countries.¹

Russian data suffer from a number of additional problems. It is widely believed, for example, that as many as half of the registered firms that are counted in Russian estimates do not really operate, while many firms that do operate are not registered. Further, tax law creates an incentive for some firms to break-up into multiple firms to reduce their tax liabilities. Thus, the estimated number of SMEs and other indicators may be significantly overstated or understated. (See Appendix 5 for a fuller discussion of these data issues.)

¹ In a nod to modifying the standard definition of SMEs to take into account the unusual Russian environment, the SME Observatory Report extended the category of medium-sized enterprises in Russia to 500 employees, rather than the 250-employee level that is used in the EU. The report explains “since the starting point of Russian economic reform in the early 1990s witnessed a size distribution of enterprises distorted toward larger enterprises that has not yet been entirely overcome... this higher cut-off point probably more accurately reflects medium-sized enterprise activity in current Russian circumstances than would use of the European Union definition [of 250 employees].” (Quoted from the Russian SME Observatory Report 2001, footnote on page 17.)

The Observatory Report's efforts to correct for a number of the aforementioned definitional and measurement difficulties resulted in a changed picture of SME development in Russia. According to that report, Russia does not lag developed countries by nearly as large a margin as Goskomstat figures suggested. Instead of roughly 13% of total employment accounted for by SMEs, the SME Observatory Report suggests the more accurate figure is no lower than 45%. Other measures of the importance of SMEs in Russia were similarly adjusted upwards, as shown in the following table.

Table 1
Alternative Estimates of the Importance of SMEs in the EU and Russia

	EU	Russia - SME Observatory Report	Russia Goskomstat
SMEs as % of total enterprises	99.8%	=>90%	
SMEs as % of total employment	65.8%	=>45%	13%
SME sales as % of total sales	56.7%	=>40%	11%
No. SMEs/1,000 people	45	37	6

Source: Russian SME Observatory Report 2001

All data for 2000

Some measures of the importance of Russia's SMEs lag more seriously behind the EU. The SME Observatory Report points out, for example, that SMEs in Russia account for a far smaller proportion of total tax proceeds than their economic importance would suggest, raising other questions about the nature of SME development in Russia.

Table 2 shows the sectors in which SEs and IEs are active. Trade and catering are the leading sectors for both types of SMEs, accounting for more than two-thirds of IE businesses. Transport and communications are also important to IEs, whereas industrial production and construction are more important to SEs.

Table 2
Sectoral Breakdown of SEs and IEs for Russia

	SEs	IEs
Trade and catering	46.3%	67.5%
Other	16.1%	15.7%
Industrial production	15.3%	5.8%
Construction	14.4%	1.2%
Science	3.5%	0.1%
Transport and communications	2.6%	8.9%
Housing, utilities, consumer services	1.7%	0.8%

Source: Russian SME Observatory Report 2001

Data for SEs from 2000; data for IEs from 1998

SMEs in the RFE

By at least one key measure, SMEs in the RFE are slightly more developed (on average) than in the rest of Russia. Observatory Report data indicate that in the year 2000 there were more SMEs per thousand inhabitants in the RFE (39) than in Russia as a whole (37). Using data from that report, Figure 1 below suggests that the number of SMEs per thousand inhabitants in the RFE is exceeded only by the Northwestern Okrug.

Figure 1

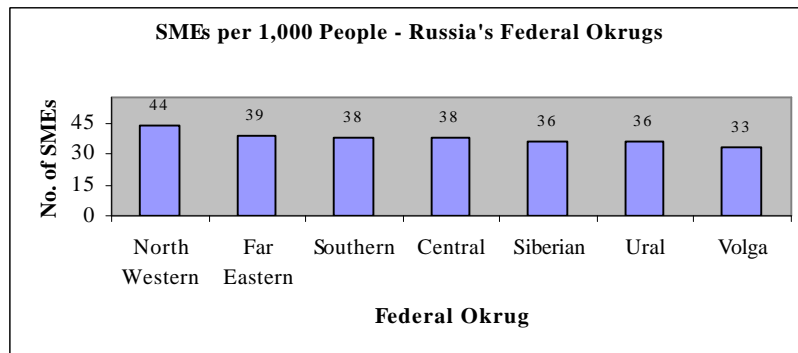
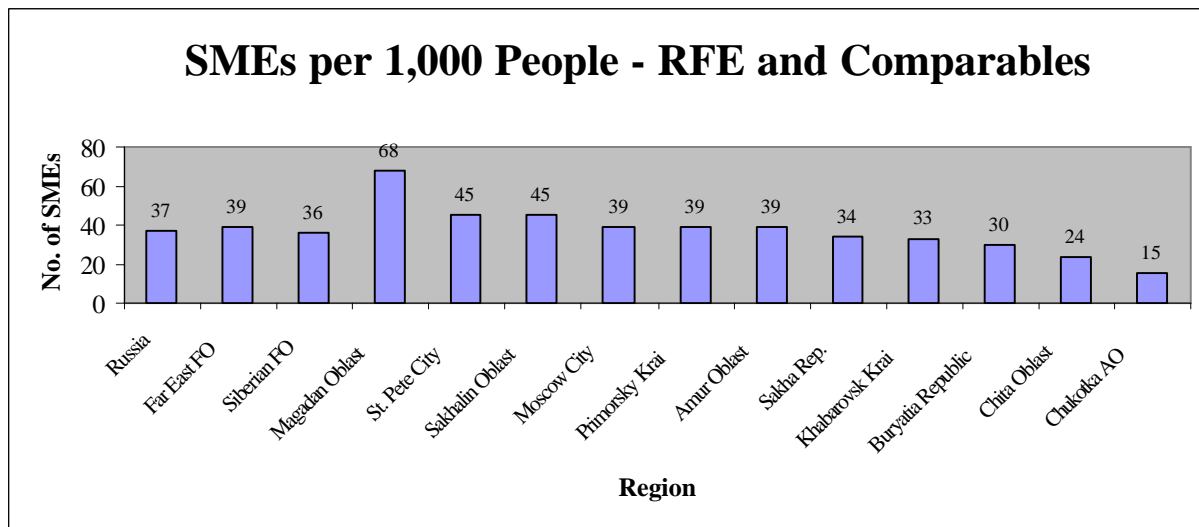


Figure 2 illustrates the considerable variation among selected regions with respect to this indicator of SME's role. Consistent with the anecdotal observations of the assessment team, the Chita Oblast in the Siberian Federal Okrug trails with only 24 SMEs per 1,000 people. Leading the pack – both in the RFE and in Russia overall – is Magadan Oblast with 68 SMEs per 1,000 people. Among the regions that formed part of this assessment, Sakhalin Oblast posted the highest level of SME activity with 45 SMEs per 1,000 people.

Figure 2



However, assessing the data through a different prism suggests that, contrary to positive SME density indicators, all is not well with SMEs in the RFE – thus underscoring USAID/Russia’s focus on SMEs in the Russian Far East in particular. The SME Observatory Report assesses the demographic dynamics of SMEs in Russia, by comparing the total number of IEs and enterprises that are established each year to the total number that are liquidated. As explained above, these and all other data on SMEs in Russia are fraught with problems, in this case not disaggregating by size of enterprise, thus dampening its relevance for assessing SMEs. These data provide at least a starting point for discussion, underscoring the problems that face SMEs in the RFE.

Figure 3

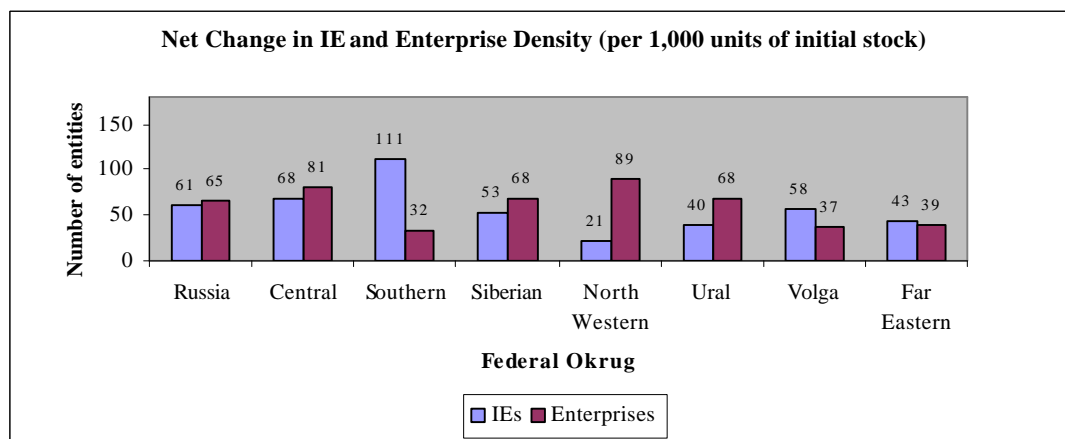


Figure 3 shows the net change in total IEs, registered enterprises and total enterprises by Federal Okrug. Net change is calculated by subtracting the number of entities in each category that were liquidated during the reporting period from the number of entities of each type that were established during the period (i.e., the birth rate minus the mortality rate). The figure shows that in 2001 there was a net increase in RFE IEs of 43 per 1,000

existing IEs, or an increase of 4.3%. In contrast, the comparable growth rate for Russia as a whole was 61 new firms or 6.1%. Similarly, the RFE's 3.9% growth rate for registered enterprises was significantly less than the 6.5% national growth in this category.

III. Findings: Donor Assistance for SME Development

The donor community has established a considerable variety of programs that are intended directly or indirectly to foster the growth of SMEs in the Russian Far East. This section will provide brief summaries of programs financed by USAID and by other donor organizations.

A. USAID Programs

USAID has invested in various efforts to support SME development in the RFE. The assessment team has grouped these into four categories:

- Improving business skills
- Expanding credit availability
- Improving the policy and regulatory environment for SMEs
- Exploiting opportunities in selected sectors

1. Improving Business Skills

The Regional Small Business in the Russian Far East program is operated by the American Russian Center (ARC) of the University of Alaska/Anchorage (UAA). This program has established three business training centers (or business support institutions, BSIs), one each in Khabarovsk, Magadan and Yuzhno-Sakhalinsk. The three centers, often referred to as ARCs, provide a basic business course several times each year and a series of short courses on specialized topics. Trainers include Americans provided through the UAA cooperative agreement and Russians associated with the centers. Selected students are offered the opportunity to take a follow-on business training program in Anchorage.

The organization model for the three ARC centers is highly unusual for a USAID-assisted activity. Normally, USAID grantees and contractors provide technical and other types of assistance to develop host country private or public sector organizations. In contrast, the ARCs, although they have Russian juridical status, are effectively dependencies of the UAA, which controls their finances and decision-making about programs. This structure creates a form of “partnership” that seems to be at odds with USAID’s “Russianization” strategy.

A July 2000 evaluation of USAID programs to develop business skills² reported that the ARCs were among the best of the Russian BSIs, but also by far the most expensive. That evaluation was critical of the program’s organizational structure, and it recommended a number of actions to reduce costs and to increase revenues. UAA has initiated action to implement a number of those suggestions. It remains unclear, however, when and if the three ARCs will become sustainable, independent Russian institutions.

² “The Evaluation of USAID Programs to Develop Business Skills in Russia,” the CARANA Corporation; July 2000

The Morozov Program. Organized by the Moscow-based Academy of Management and Market (AMM), Morozov is a loose, nationwide association of approximately 60 independent, business support institutions. AMM develops and disseminates business training materials to its associated BSIs and provides periodic training sessions in Moscow for their staffs. USAID support subsidizes these central functions; financial resources do not flow to the associated BSIs. The Morozov centers offer short, business training courses, typically to people interested in starting a business or currently running a very small enterprise.

The above-mentioned year 2000 evaluation of USAID business skills programs found that many of the Morozov BSIs were attached to state-run educational institutions. In comparison to BSIs supported through other USAID programs, the Morozov centers tended to be managed more as social institutions than businesses and to focus almost exclusively on training, with little emphasis on consulting or other revenue-generating activities. No attempt was being made to assess the impact of the training. Morozov centers in the RFE (and in Siberia) reported that they felt extremely isolated from the Moscow operation and indicated that they benefited little from it. For example, they often lacked the resources to attend the Moscow training sessions. The current assessment team visited only one Morozov center. The information provided at that center was consistent with that reported two years ago.

The Entrepreneurial Business Services (EBS) Program. Functioning from 1999 to 2001, the EBS program was a Russia-wide program. Unlike its predecessor program (implemented in the RFE by the International Executive Service Corps, IESC), which provided American business volunteers directly to Russian businesses, the EBS program provided American business volunteers through Russian BSIs. BSIs were paid for setting up the assignments and for hosting the volunteer. Additionally, some volunteers were assigned to strengthen the BSIs and/or to provide consulting to Russian firms jointly with a Russian consultant from the BSI. Thus, EBS was intended to strengthen the BSIs as well as provide consulting services directly to Russian SMEs. EBS was implemented east of the Urals by a consortium that included ACDI/VOCA, Winrock International and the University of Maryland's Center for International Reform and the Informal Sector (IRIS). Winrock International had primary implementation responsibility in the RFE.

The successor to EBS, the ***Integrated Business Services (IBS)***, does not currently operate in the RFE. This project is implemented by the Citizens Democracy Corps (the contractor that implemented EBS in western Russia). In the IBS program, USAID has continued its efforts to make U.S. volunteer-based programs increasingly work through and support the development of Russian BSIs. Under IBS, all U.S. volunteers must be “paired” with a Russian consultant from the BSI that arranged the assignment with the Russian client firm. IBS also organizes national workshops to train BSI trainers and consultants, a concept borrowed from Morozov and from the IRIS program.

Junior Achievement. Russia's Junior Achievement (JA) program, now the second largest in the world, was founded in 1991. Junior Achievement provides a school-based extra-curricular program to teach young Russians in elementary and secondary schools about

the workings of market economies. JA's program currently is taught by 10,000 teachers in 6,500 primary and secondary schools and serves 384,000 students. USAID finances much of the cost of training teachers and materials production and distribution. The cost of teachers' time and facilities is paid for by the Russian school system.

2. Expanding credit availability

Counterpart International. Counterpart International received a grant to establish the Counterpart Enterprise Fund, a microfinance program in Khabarovsk. The program suffered large losses in Russia's 1998 financial crisis, but has rebounded well. The Fund's loan portfolio, approximately 400 loans totaling \$900,000, is virtually delinquency free. Loans are made to individuals for as little as \$100; group loans are common. All loans are currently denominated in rubles. Approximately 60% of loans are to firms engaged in retail trade and services. Loans are not made for start-up capital. Seventy percent of Counterpart's clients are women.

The Counterpart Enterprise Fund offers loans to borrowers who generally lack collateral and who would not be eligible for bank credit. The only other source of such funds in the Khabarovsk area is from a lending fund established by the Krai government. However, that fund is so small (with capital sufficient to make loans totaling only \$10,000/year) as to be irrelevant.

ACDI/VOCA. USAID provided a grant to ACDI/VOCA to establish a microfinance program in Yuzhno-Sakhalinsk. The ACDI/VOCA program utilizes both group and individual borrowing methodologies. Using the group lending method, the program makes loans ranging from \$25,000- to \$50,000, typically to groups incorporating five to nine borrowers. The outstanding loan portfolio is \$2 million and has a default rate of 5%. The fund serves clients who cannot obtain credit from commercial banks; commercial banks are prevented from lending to many of these SME firms because of Central Bank rules requiring collateral, audited statements, business plans and the use of settlement accounts at the lending bank. The fund officers report that demand is high, and it is seeking additional capital from other sources.

3. Improving the policy and regulatory environment for SMEs

USAID has financed a variety of programs that have attempted, sometimes as a secondary goal, to improve the policy and regulatory environment for SMEs.

On the federal level, USAID financed a large multi-year **Fiscal Policy Reform** Program, administered first by the Harvard Institute for International Development (HIID) and subsequently by Georgia State University (GSU). That program assisted federal authorities to assess a variety of tax policies, with a view toward making them less burdensome on business, more transparent, easier to administer, less onerous to taxpayers, and more equitable.

The Mission's assistance through the *Financial Services Volunteer Corps* (FSVC) has assisted the Central Bank to improve its policies and oversight responsibilities with respect to commercial banks.

USAID's *Strengthening Economic Think Tanks Program* (SETT) has provided grants to Russian social science research organizations to undertake a variety of studies, some of which bear on the environment for SMEs.

More recently, USAID has agreed to finance a series of studies carried out by the *Center for Economic and Financial Research* (CEFIR). These studies, described elsewhere in this report, will monitor changes in the policy and regulatory environment throughout the Russian Federation.

USAID has initiated the *SME Policy Reform Project implemented by The Center for International Private Enterprise* (CIPE). CIPE works with the Russian Chamber of Commerce to form coalitions of businesses and regional chambers of commerce throughout Russia. Regional chambers are in turn expected to strengthen local chambers and associations that can represent business interests and educate the public sector officials and the public about issues of concern to SMEs.

Specifically in the RFE, USAID financed the *Sakhalin Program of Assistance to Business Associations*, a now-completed effort administered by the CARANA Corporation to build the capacity of Sakhalin business associations. These associations were expected to lobby the government for improvements in policy and regulation and for more equitable and transparent implementation.

4. Exploiting opportunities in selected sectors

USAID has financed two programs that, along with other objectives, encourage SMEs to exploit the opportunities in selected sectors.

The Forest Resources and Technologies (FOREST) project implemented by Winrock International seeks to preserve and protect forest resources in the RFE and at the same time to foster their commercial exploitation on an ecologically sound basis. More specifically, FOREST seeks to encourage the processing of timber and expansion of activities to collect, process and market non-timber forest products (NTFPs).

The Replication of Lessons Learned (ROLL) project implemented by the Institute for Sustainable Communities (ISC) is an environmental program that includes a focus on encouraging environmentally sound and sustainable development. ROLL has six regional support centers, including ones in Khabarovsk and Ulan-Ude. ROLL's grants have supported a number of ecotourism initiatives, including for example a program to develop a network of bed and breakfast establishments in Yakutia.

B. The Eurasia Foundation

Headquartered in Vladivostok, the Eurasia Foundation - RFE makes grants in the region covered by this study. Many of those grants are related to the development of SMEs. These projects are typically intended to impact underserved areas, including particularly smaller cities and rural areas. Eurasia's SME grants typically include a social development component. The program has operated in the RFE since 1993.

Eurasia grants are not concentrated in specific areas but are spread across the RFE. This is consistent with Eurasia-RFE's focus on demonstrating the success of concepts for replication and reaching underserved areas. Eurasia currently has ten active SME-related grants in the region: two in Khabarovsk Krai; two in Primorsky Krai, and three each in the Chita Oblast and Sakhalinskaya Oblast.

The objectives of Eurasia's SME-related grants are as follows:

- building and strengthening business credit associations
- promoting investment
- promoting credit unions
- strengthening local institutions
- fostering business centers in under-served areas
- helping investors and scientists to bring ideas to market

The Eurasia-RFE program receives five-year grants from USAID, its primary funding source. A grant period of this length permits Eurasia to conduct its program with a longer-range view than most other grantees. In addition, Eurasia-RFE seeks other sources of funding to achieve its goal of sustainability as a Russian entity.

C. Other Donors

EBRD Russia Small Business Fund (RSBF), the largest project of the European Bank for Reconstruction and Development, London, was established in 1994 to support SMEs in Russia. The capital of the RSBF is \$450 million. The EBRD has provided 50% the RSBF's capital, while the balance is sourced by the G8 countries (excluding Russia). The RSBF is a long-term project with a life to at least 2010.

The RSBF provides credits ranging from \$100 to \$150,000 for small enterprises of up to 80 staff through partner banks. Ninety per cent of loans are made in rubles. Currently, the average loan term is nine months, but a term of up to three years may be considered. Interest rates are up to 2% below prevailing commercial rates. Due diligence is always conducted before loan commitment. Collateral is required but almost any asset with value can be used. Guarantors' assets may be accepted as collateral.

Eighty-nine percent of borrowers are sole proprietorships or individual enterprises. These firms have an average of nine employees. Just under half of micro clients are women. However, the proportion of women is more than half among small credit users, and less than half among larger credit ones. Approximately 64% of borrowers are firms involved

in trade, 17% are in the services sector, and 19% are in manufacturing. Loans may not be utilized to finance arms/weapons, drugs, strong alcohol, currency speculation, gambling or ecologically harmful activities.

The RSBF began its RFE program in 1997. The partner banks in the RFE are Sberbank, Dalnevostochny Bank, and KMB Bank. The program now operates in Vladivostok, Khabarovsk, Yuzhno-Sakhalinsk, Magadan, Birobidzhan, and Petropavlovsk-Kamchatskiy. It is being expanded to Yakutsk and Blagoveshchensk.

Since 1997, the RSBF has advanced about 5,900 loans in the RFE. The total capital is more than \$47 million. The default rate is 1% - best in all of Russia. In the RFE, the RSBF is currently making 200 loans per month through the partner banks; loans average from \$7,000 to \$10,000.

Japan. There are seven *Japan Centers* in Russia, three of which are in the RFE. The center in Khabarovsk was established in 1994, those in Vladivostok and Yuzhno-Sakhalinsk in 1996. Japan Centers deliver seminars led by Japanese lecturers on marketing, finance, accounting, foreign trade, etc. for Russian businesspeople. The objective is to transfer Japanese business experience and know-how. All seminars and courses are free of charge. Center activities are funded by the Ministry of Foreign Affairs of Japan.

RFE Japan Centers also offer industry-specific courses focused on the region's leading industries, e.g. timber industry in Khabarovsk, seafood processing in Yuzhno-Sakhalinsk. In 2002, the Japan Center in Vladivostok organized a "Round Table for Japanese Tourism in the RFE" for the tourist companies of Vladivostok and for the Vladivostok city administration. That Center also delivers seminars in conjunction with the Far Eastern State University (FESU) led by Russian experts.

The ***Regional Venture Fund (RVF)*** was started in 1994 as a \$50 million direct investment fund, with \$30 million from EBRD and \$20 million from Japanese investment bank Daiwa. The mission of the fund is to promote investment in the RFE and Eastern Siberia. The RVF invested, mostly before the crisis of 1998, in food processing, furniture production, transportation, and aluminum framing companies. The size of investment varies between \$300,000 and \$3 million. Currently, the RVF is in a wind-down period targeting liquidation by the end of 2004. While one of the key objectives of the fund was to promote additional venture capital investment in the RFE, there has been little subsequent interest on the part of private venture capital funds in the RFE.

The Center for Citizen Initiative – Productivity Enhancement Program (CCI-PEP) is run by the Department of State, Bureau of Education and Cultural Affairs and is supported by Rotary International and local Rotary Clubs in Primorsky Krai. This program identifies and selects non-English-speaking Russian business owners and managers of SMEs for 3-4 week business training in the US. Typically, a Rotary Club member family hosts visitors. The objective of the program is to enhance the production

of Russian goods and services. Since 1998, 250 businesspeople from Primorsky Krai have participated in the program.

The Foundation for Russian American Economic Cooperation (FRAEC), a Seattle-based NGO, was founded to assist American and Russian businesses to do business with each other. FRAEC has a special focus on the Russian Far East. It has pursued and implemented a wide array of activities in various fields, including SME support and development in the RFE.

Currently, FRAEC is administering the ***U.S.-RFE Partnership*** Activity for USAID and is responsible for the award and monitoring of grants and technical assistance under this program. Among the strategic areas of focus is SME development, i.e. to develop policy advocacy to promote trade, business development and investment, and to facilitate mutually beneficial collaborations of business-related training institutions to disseminate best business practices, train young business professionals and enhance institutional capacity strengthening. Grants range from \$70,000-\$100,000. The first round of ten grants (1992) included three for SME development activities: a grant to expand the microenterprise credit program of the Counterpart Fund in Khabarovsk, a grant to the Institute for Sustainable Communities in conjunction with Russia's Far East Center for Tourism Development to promote ecotourism, and a second ecotourism grant to the Earth Island Institute in conjunction with Russia's Adventure Tourism and Mountaineering Federation of the Buryat Republic.

FRAEC also operates the ***Community Connection***, a professional exchange program funded by the U.S. Department of State's Bureau of Educational and Cultural Affairs. The program focuses on business and management skills, business development policy, non-profit management and educational policy. It has brought over 6,500 professionals from the Former Soviet Union to the United States since 1994.

International Research and Exchanges Board (IREX) manages ***Business For Russia***, a State Department-sponsored program that provides five-week internships for Russian entrepreneurs at American businesses in communities across the United States. Internships are free of charge and focus on privately owned SMEs in different fields of business. Participants are selected through open competitions conducted in targeted areas by an independent commission composed of American and Russian experts. This program is funded by the U.S. Department of State's Bureau of Educational and Cultural Affairs. Since 1994 more than 3,000 entrepreneurs from Russia have participated in internships in the United States.

Special American Business Internship Training Program (SABIT) places middle and senior level managers, scientists, engineers and other specialists from Russia in internships with businesses and organizations throughout the United States. Internships focus on industry training, and exposure to western management concepts and market-based economic fundamentals.

As part of the U.S. Department of State's U.S.-Russia Regional Investment Initiative to promote economic restructuring in specific regions of Russia, SABIT trained 90 managers and engineers from the Russian Far East. Six, six-week sessions took place from the fall 1997 to the fall 1999, and focused on oil and gas exploration and production, mining, renewable energy resources, customs, port development, and the timber industry. This program has been completed.

Currently, SABIT sponsors the Russian Far East Energy Program. Two three-week sessions will focus on Energy Efficiency in the Construction Industry, and Renewable/Alternative Energy.

Business Information Service for Newly Independent States (BISNIS) is the U.S. Government's primary market information center for U.S. companies exploring business opportunities in Russia and other Newly Independent States (NIS). **BISNIS** was established in 1992 under the Freedom Support Act and is a part of the U.S. Department of Commerce's International Trade Administration. It has 10 representatives in Russia, including three in the RFE: in Vladivostok, Khabarovsk, and Yuzhno-Sakhalinsk. BISNIS provides reports and analyses on business conditions in the RFE. In 2000, BISNIS launched a Russian-language web site to familiarize the NIS business community with U.S. practices, resources, and opportunities.

IV. Findings: Key factors influencing SME Development in the RFE

Based on its research and interviews, the assessment team identified seven factors that significantly influence the growth of SMEs in the RFE. Each of these factors is discussed briefly in the following pages.

A. The Russian Macroeconomic Environment

Background

The macroeconomic environments in Russia and in the RFE over the past few years have been favorable for SME development. The dramatic improvement that the Russian economy has experienced since 1998 has been a function of three key factors:

- **Strength in natural resources prices:** Russia's export revenues, government budget surpluses, reserve levels, currency stability, direct and portfolio flows, and a range of other indicators are highly correlated with natural resource prices. Strength on this front over the past few years has been a key contributing factor to the positive environment for SMEs.
- **The benefits of devaluation:** The devaluation of the Ruble that resulted from the August 1998 financial crisis increased Russia's competitiveness in a variety of industries and has been critical to the subsequent growth of the Russian economy.
- **Perceived changes in the investment climate:** In spite of the fact that Foreign Direct Investment is still lagging, international and domestic investors' perceptions of Russia and of the Russian economy have improved markedly over the past few years. Investment and economic prophecies and sentiment often tend to become self-fulfilling. This perceived positive momentum of Russia's economy has been reinforced by the Putin government's reform program. The stage is set for expanding investment in the Russian economy.

As a result, Russia's macroeconomic and fiscal indicators are very solid. GDP grew by 9.0% in 2000, 5.6% in 2001, and is on track to grow nearly 5% in 2002; inflation has been tamed to the low double digits, and continues to fall; capital flight dropped nearly 50% in 2002; the current account surplus amounts to more than 11% of GDP in 2001; the exchange rate is relatively stable; and wage and government arrears are no longer a concern. In a global economic environment typified by recession, Russia stands out as a solid performer. Growth in the RFE has by and large kept pace with the rest of Russia; per capita income in 2001 in the region was roughly the same as the Russian average.

SMEs are only one beneficiary of an upbeat macroeconomic environment, but in many ways they benefit disproportionately. Rising discretionary income (nominal dollar wages in Russia were up nearly 27% over the first ten months of 2002) disproportionately benefits the retail trade and services industries, as consumers are increasingly able to look beyond their immediate needs to purchase non-essential goods and services. SMEs are particularly well suited to meet these shifts in demand, as they are more flexible and better geared to address new niches in the market (particularly in Russia) than more established enterprises.

Key Obstacles

The Russian macroeconomic environment still faces many problems. The dependence of the economy on natural resource prices, and the consequent case of “Dutch disease”³ from which the Russian economy suffers, is a key risk to economic growth and stability. The Putin reform program has yet to prove itself in the implementation stage. Concerns remain that the execution of the various stages of the reform program will fall far short of what will be required to ensure that Russia’s present growth spurt is sustainable over the long term.

Much of industrial Russia has yet to be restructured and reformed, and much of the command economy infrastructure remains intact. The so-called “virtual economy” still looms over large swatches of the economy – such as electricity generation and gas – that are still dominated by state-controlled monopolies. In spite of increased confidence in the Russian economy, foreign direct investment – key to long-term economic growth – remains anemic at best; since 1994, on a per capita basis, Russia has received less than one-tenth of the foreign direct investment that has flowed to the Czech Republic, for example, and absolute inflows into Russia were lower in 2001 than in 1999.

On another front, regional and income disparities are large and increasing. For example, from 1997 to 2001 the city of Moscow received nearly 40% of total foreign direct investment, while the three most popular regional beneficiaries accounted for nearly 60%. Wage growth, economic opportunity, the impact of reform, and virtually every other indicator of macroeconomic health is more apparent in Russia’s key urban (primarily Moscow and St. Petersburg) and natural resource centers (such as Sakhalin and Krasnodar) than elsewhere in the country. This is of particular relevance to the RFE, which has received only a tiny percentage of total investment flows into Russia, and in many other ways has only tangentially enjoyed the Russian economic boom. On another front, as is the case in many developing economies, economic growth of the past few years has disproportionately benefited the wealthier segments of the population, leaving the vast majority of Russians remain poor and their situation unimproved.

SMEs stand to be disproportionately disadvantaged if the Russian economic renaissance stalls. One danger of the shift of SMEs toward higher-end services and products – in line with increased disposable income – is that demand would likely plummet as consumer demand for higher-end goods and products drops more rapidly than for staple goods. However, this is little more than an unavoidable risk of business growth; and, indeed, many SMEs will remain focused on trade in basic goods, which tend to be less disrupted in an environment of flat or negative economic growth.

Opportunities

The nature of economic growth, of course, is that no donor activity can impact it directly – but much donor activity impacts it indirectly. Some of the broad, macro-level efforts undertaken by donors – for example, in the realms of fiscal and banking reform,

³ That is, the over-reliance on and over-investment in primary sector infrastructure and entities, while placing insufficient focus on investment in secondary and tertiary sectors, which in the long term causes severe distortions in the structure of the economy)

education, and health, as well as in SME development – have helped create an environment amenable to long-term sustainable economic growth. By making efforts to address the barriers to economic growth and investment, donor activities have promoted economic growth indirectly.

Donor activity can also play a central role in promoting growth and development in the vast regions of Russia, outside of the key investment and urban centers. It can assist those in most need of help, that is, the poorer segments of the Russian population. USAID efforts in the RFE have represented a strong effort to ensure that prosperity in Russia as a whole also benefits the Far East. Many programs – such as MFIs and business skills training – are specifically designed to help those would-be small businesspeople who have not enjoyed much of the fruits of Russia's recent economic boom, and who are trying to search for new ways to improve their standard of life.

B. The Geography of the RFE

Background

Geography has a profound impact on business in the RFE. Two of the region's primary characteristics are its vast size (twice that of the U.S. 48 contiguous states) and small population (barely 7,000,000). The Trans-Baikal region, part of which the assessment team visited, contributes another 3.5 million people.

Vladivostok is the largest city with a population of only 628,000. Other important cities include Khabarovsk (600,000), Ulan-Ude (390,000), Chita (313,000), Komsomolsk-na-Amur (287,000), Blagoveshchensk (217,000), Yakutsk (191,000), Nakhodka (183,000) and Yuzhno-Sakalinsk (165,000.). Other cities with significant populations include Ussurisk, Birobidzhan, Petropavlovsk-Kamchatskiy, Magadan and Anadyr.

As road links are limited and distances great, most travel and transport between cities in the RFE is by rail. The distance on the Trans-Siberian railway between the region's two largest urban centers, Vladivostok and Khabarovsk, is 450 miles. Yuzhno-Sakhalinsk is 190 miles from Khabarovsk and 590 miles from Vladivostok. These distances are relatively small compared to those between other RFE cities; from Khabarovsk, it is 850 miles to Chita (44 hours by train) 1100 miles to Ulan-Ude, and 970 miles to Yakutsk, (reachable only by air for much of the year).

The RFE's location, far from Western Russia but close to China, both Koreas, Japan and the United States, is a major economic and political influence. To the West and South is China and Mongolia. The Amur River defines the southern border with China and collects water from a watershed on both sides of the border approximating the size of the contiguous 48 states. It also provides a major commercial waterway. The RFE's coastline stretches almost 2,000 miles from the North Korean border at Tyumen to the northern tip of Khabarovsk Krai, forming the western shore of the Sea of Japan and the Sea of Okhotsk. These are prime fisheries for the RFE, Japan and Korea.

The region's major proximate trading partners are China, Japan, South Korea and Mongolia.⁴ The 1,000-mile Russian-Chinese border winds from the Tyumen River north, and then west to meet the Russian-Mongolian border. The Mongolian border continues another 500 miles across trans-Baikal. The Chinese population along the border, said to approach 100,000,000, present both a vast opportunity and a perceived strategic threat, a fact that continuously shades attitudes in the region as well as Moscow, some 5,000 miles to the west. Interviewees in cities close to the border often mentioned the economic importance of the "shuttle" trade and described some limited joint investments in small enterprises.

In addition to vast timber and important fish resources, the RFE has many important mineral resources such as gold, diamonds and coal. Like most extraction industries, these are capital-intensive and dependent upon economies of scale and are therefore dominated by large firms. More recently, very significant oil resources have been discovered on and near Sakhalin Island and in the northern part of Primorski Krai. (See Section V.C. Oil and Gas.)

During the latter part of the Soviet period, extensive military capabilities were established in reaction to the long border with China. The military complex became one of the major industries of the area. In the process, the Soviet Union made the RFE a Russian military bulwark and closed much of the region to foreigners and non-resident Russians. A major decrease in military investments during the last decade has forced major economic changes in the area, setting the stage for the rise of entrepreneurship.

Obstacles

The long distances between modest-sized markets tend to increase the costs of distributing SME (and other) goods and services. Typically, these costs make it more difficult to operate successful enterprises. In manufacturing, for example, the small and dispersed population represents an important constraint on achieving economies of scale. However, some SMEs might indirectly benefit from the RFEs unusual geographic characteristics, for example affording some degree of "protection" from more efficient or better quality producers in other locations.

Weather is another important geographic factor for SMEs in the RFE. The severe weather conditions from December through April limit agriculture and harvesting of timber and non-timber forest products. It creates obstacles to transportation, raises energy costs for heating, and generally interferes with any economic activity performed outdoors. In addition to the cold, Primorski Krai has the world's northernmost monsoon climate, which, when combined with low temperatures can result in formidable weather conditions. The limited growing season and lack of agricultural development dictate that much food stock must be imported from foreign sources or other parts of Russia. In sum, vast distances, sparse population, harsh weather and geographic diversity are the backdrop for all economic activity in the RFE and trans-Baikal areas. Rich natural and

⁴ Being part of the same country, Siberia and Western Russia are not thought of as "trading partners."

mineral resources notwithstanding, SME development is hostage to the area's unique and challenging geography.

Opportunities

Important and valuable natural resources are abundant in the RFE. The forests are said to contain one-fifth of the world's standing timber. With these huge forest reserves, the RFE is also blessed with a wide variety of non-timber forest resources. These include foods such as nuts, honey, sap, berries and mushrooms; organics and bio-additives such as ginseng; algae, lichens, mosses and other natural sources for various pharmaceuticals; floral greenery and decorative plants. (See Section V.B Non-timber Forest Products.)

The region's Pacific location has led to the development of important economic ties with Pacific Rim economies, including a special relationship with Alaska and the U.S. Pacific Northwest. Goods entering the ports of Vladivostok and Nakhodka originate from countries as far away as Australia and New Zealand and are commonly found in RFE markets. Travelers from Pacific Rim countries constitute the main source of foreign tourists and business people. Russians from the west and north also provide impetus to the tourism industry.

C. Policy and Regulatory Environment

Background

The legacy of the Soviet Union determined that early post-Soviet policies toward business were more focused on regulating and controlling, rather than facilitating and encouraging free enterprise. The Soviet approach toward the individual's freedom of activity – that only those activities specifically permitted by law are permissible, whereas all other activities are assumed to be prohibited – is anathema to entrepreneurship. Additionally, the core distrust of the free market that permeated the ideological underpinnings of the command economy meant that free enterprise faced a steep uphill battle in the years immediately following the fall of the Soviet Union.

Reliable studies have pointed to inordinately complex registration and licensing procedures, excessively high tax rates, labor policies that made it difficult to punish or dismiss unproductive workers. These and other policies attributable to the Soviet legacy greatly increased the cost of doing business and slowed the growth of SMEs.

Both “the good news and the bad news” about these policies and regulations is that their implementation was almost always negotiable. This was good news in that businesspeople could negotiate with the tax police, licensing agencies, inspectors and others to lower the costs to a level that was affordable. As a result, many businesses were established, and some prospered. The bad news was that “negotiation” perpetuated corruption, undermined the rule of law, and rewarded firms that negotiated well with government rather than those that competed efficiently in the market.

As noted in Section II above, Russia's leadership has embarked on a series of policy reforms to create an environment more conducive to SME growth. The team's

assessment of the SME environment in the RFE occurred within the context of these various influences -- the legacy of the past, the prevalence of negotiated policies and regulations, and the effort at the national level to change the policy and regulatory environment.

Key Obstacles

The environment for policy and regulatory reform has improved dramatically since 2000. The Putin government has significantly increased the stability and predictability of the macro-level political and economic environments, and in turn has brought about a range of reforms intended to improve the operating environment for SMEs. (See Section II.C.)

Federal level reforms represent only a first step, however, and many problems remain for SMEs. Surveys of businesspeople who own small and medium sized businesses have shown that policy and regulatory issues are among the most serious obstacles they face. According to the spring 2002 CEFIR report, the specific problems for SMEs include the level of taxation; the system of tax administration; excessive federal and local government regulation; and corruption. Within the realm of regulation, the survey found that the purchase or lease of premises, licensing, certification, and tax inspections are the most onerous problems for SMEs.

There are also broader aspects of the policy environment (i.e., not pertaining specifically to SMEs or even to business in general) that impede SME development. These obstacles include the lack of rule of law, the need for civil service reform, excessive cross-subsidization that distorts energy and other markets, and the need for banking reform.

The CEFIR study identified a number of onerous regulatory problems that are inhibiting SME development in the RFE. Examples include:

- **Sakhalinskaya Oblast:** Sanitation and ecology-related inspections; and the total cost of registration;
- **Amurskaya Oblast:** Ecology and labor protection inspections; and
- **Khabarovski Krai:** Ecology and labor protection inspections, and the total number of inspections overall (the region was the third-worst of the 20 areas of Russia surveyed).

The assessment team's interviews confirm the CEFIR findings. Almost every businessperson with whom the team met identified these as key problems. One businessman summed up the regulatory situation indicating "Any fireman can close you down any day. You never know what will happen tomorrow." Another company reported spending several hundred thousand rubles in licenses and fees for an amusement park, even before breaking ground to begin construction. Myriad businesses in the RFE reported similar challenges. Some indicated that they had suspended plans for new businesses or new product lines because of these problems. Representatives of business organizations echoed these responses. Even government officials that the team interviewed (who were those responsible for SME development, not inspectors) often acknowledged the prevalence of these problems.

Interestingly, although some businesspeople indicated that registering a business in their geographic areas was now simple and quick (three to five days), almost none of these people offered a positive interpretation of the changes coming out of Moscow. These changes were described by various people as too complicated, making matters worse, coming so fast that one could not keep up with the current requirements, and ill-conceived, suggesting lingering suspicions in the business community.

Opportunities

The Putin government has made improvement of the operating environment for SMEs a priority. The federal government has passed a range of legislation that, upon implementation, will address many of the obstacles discussed above, thereby removing barriers that stand in the way of SME growth. In turn, a number of local governments in the RFE report that they have their own programs to facilitate SME growth.

The implementation of these reforms constitutes one of the biggest challenges facing SMEs, as well as the greatest opportunity. Ensuring that changes benefiting SMEs filter through every layer of government and administration will be the key test of the recent federal reforms. This is a particular challenge in the RFE, given the thousands of kilometers that separate it from Moscow, and thus the possibility that implementation will be even more difficult to bring about and enforce.

Making important analytic information available and supporting educational activities would be useful interventions in this regard. Facilitating the development of business associations and organizations at the local and regional level would also be of value.

D. Credit Availability

A common complaint of small businesspeople around the world is that they do not have access to affordable capital. This contention rings particularly true in Russia, reflecting the embryonic state of the country's banking system and financial markets. Russian SMEs have been forced to search for alternate sources of funding – which, in turn, has prompted donors to search for alternate methods for providing financing to SMEs. What follows are descriptions of the key potential sources of credit for SMEs in the RFE -- banks, non-bank financial institutions (NBFIs) and micro-finance institutions (MFIs), regional support funds, leasing, and venture capital -- along with the assessment team's determinations of the opportunities in each arena.

Banks

Background: It has almost become a cliché to refer to Russia's banks as “bank-like institutions,” i.e., entities which make every effort to appear to be banks, but which in reality are the glorified treasury operations of a small, select group of customers (who are often shareholders of the institution). Much of lending by banks in Russia is to related structures, or (in the case of state banks) to politically favored borrowers; nevertheless, Russian banks do not lend much. In 2001, total outstanding loans in the Russian banking sectors accounted for just 12% of GDP, compared with analogous figures of 25% in Hungary, 68% in the Czech Republic, and 145% in the U.S. On a term-adjusted basis,

Russia's figure would be even lower, as the term of loans is generally very short, only rarely for up to a year.

Most Russian banks ignore SMEs altogether. Virtually every SME businessperson with whom the assessment team spoke cited credit availability – and, more specifically, a dormant or non-existent banking sector – as a key constraint to SME development and growth. When banks, in principle, were willing to lend to SMEs, SME businesspeople complained of excessive bureaucratic requirements. The head of a furniture producer in Chita showed the assessment team a poster-sized flow chart that he had constructed to illustrate the numerous steps required to get a loan from the local Sberbank branch. (Earlier in the year the company had been forced to shutter operations for a month because it had not yet received a pending credit from that bank.)

In line with the national trend, the vast majority of banks in the RFE view SMEs as high-risk prospects. Other than the banks participating in donor-assisted programs focused on SMEs, the assessment team heard of only two banks making a significant effort to serve the SME clients. Those two exceptions were the Dalnevostochnoye O.V.K. in Blagoveshchensk, which says that it lends to 4,500 SME customers and makes loans as small as RUB 7,500 (U.S.\$238), and the Regiobank in Khabarovsk. Reflecting the funding problems that Russian banks face (e.g., the dearth of long-term deposits), most loans are extended for only six to nine months.

Many banks, such as Vneshtorgbank in Chita Oblast, complained that many SMEs that applied for loans often lack the requisite documentation – in part because SMEs were reluctant to “come clean” with the tax authorities, obtain government certifications, etc., if it meant that they would henceforth be taxed more heavily or subjected to more rigorous inspections. Additionally, many SMEs are unable to shoulder the considerable expense involved with developing financial statements, business plans, and other related documentation that banks require in order to extend a loan. All of this assumes that potential SME borrowers have collateral – a requirement for commercial bank lending that keeps many SMEs from even contemplating a bank loan.

Opportunities:

Hope springs eternal that change in the Russian banking sector will be initiated at the federal level. The March 2002 changing of the guard at the Central Bank of Russia was greeted as an indication that long-awaited and much-delayed banking sector reform was imminent, but the lack of subsequent progress has been disappointing. A wide range of donor efforts to bring about change at the macro level in the Russian banking sector over the past several years have yielded little; in any case, substantive change that might benefit small borrowers would take years to filter through the system.

A more promising approach is to attack these problems at the individual bank level – providing capital for SME credit while at the same time teaching Russian banks the basics of credit risk analysis and management. A small number of donors, most notably the EBRD's Russia Small Business Fund, are working directly with Russian banks to create a credit culture at the grass roots level, while funneling credit to SMEs. Through

providing capital and intensive training to selected banks, the program aims to help Russian banks achieve the necessary economies of scale to make SME lending profitable. The program presently works with a small handful of banks in the RFE, including Sberbank, Far East Bank, and Chilitbank. As of July 2002 the program's Vladivostok office, one of the program's most dynamic centers, had reportedly extended nearly 1,500 loans for a total value of \$9 million.

Additionally, KMB Bank, which receives funding from and is partly owned by the EBRD, focuses exclusively on lending to the SME sector. KMB Bank is well known throughout the RFE, although presently only 2% (or roughly \$2.7 million) of its \$135 million loan portfolio is directed toward the RFE. The mere possibility that KMB Bank was considering establishing a presence in Ulan-Ude was the subject of much speculation and interest in the SME community there.

USAID/Russia has also supported individual banks, through a loan portfolio guarantee program through which participating banks receive a 50% guarantee on loans made to SMEs. Thus far the three participating banks have made approximately 300 loans totaling \$12 million. Not all banks find this program attractive. The Far Eastern Bank in Vladivostok, for example, sees the constraint on SME lending as being the terms (interest rate and period of the loan) to the borrower, not the risk to the bank. The guarantee program, in that bank's view, would not allow it to improve its lending terms.

At this point in Russia's evolution to a market economy, donor efforts to improve SMEs' access to credit by changing the banking sector at its roots seem to have the most favorable chance of success. USAID/Russia's efforts to support the EBRD and KMB Bank while continuing to build its loan portfolio guarantee program seem highly appropriate to the needs and to the environment.

NBFIs/MFIs

Background: The Economic Development and Trade Ministry has found that bank lending accounts for just 3-5% of domestic investment financing in Russia compared with 25-35% in developing economies. This suggests that an unusually high percentage of Russian investment is financed from personal savings and firms' retained earnings. This puts SMEs – which by their nature have meager self-generated funds to reinvest – at a significant disadvantage in the Russian economic environment. The problems in the Russian banking system have fueled a search for alternative financing sources, most notably NBFIs, micro-finance institutions (MFIs), federal and regional SME support funds and other mechanisms that are discussed below.

USAID/Russia and other donors have made a significant effort over the past several years to develop NBFIs and MFIs as an alternate source of funding for SMEs. Unlike banks, NBFIs do not require collateral, which means that financing is a possibility for a broad range of SMEs. One of USAID's present efforts is the development and support of the Russian Microfinance Center, and, through the same project, the funding of MFIs throughout Russia.

The assessment team was impressed by the donor-supported MFIs it visited, including Counterpart International in Khabarovsk, and the ACDI/VOCA Micro-Credit Program in Yuzhno-Sakhalinsk. The latter reports that it has a loan portfolio of \$2 million, with an average loan size of \$25,000-50,000 (which is larger than the average MFI loan size, largely because the loans are made to groups of mutual guarantors). The Counterpart International MFI – which in December 2002 is slated to become completely self-sufficient – has close to \$1 million in loans outstanding to roughly 400 borrowers; loan sizes range in size from \$100, to as much as \$15,000 to a group of mutual guarantors. The management of the Counterpart International MFI is completely Russian. Both MFIs report very low default rates and high demand, despite interest rates (in the 35% range for Counterpart International, and considerably higher for other MFIs) that are significantly higher than those offered by banks. The terms of the loans the two MFIs extend rarely exceed nine months.

Opportunities: Microfinance institutions and other non-bank financial institutions help fill the financing gap for SMEs, and in particular target the smaller borrowers that do not have collateral for a bank loan. Although NBFIs are capital intensive, and their reach is relatively limited, if managed well they can satisfy the dual aims of extending credit to SMEs, while cultivating a credit culture. Many NBFIs eventually “graduate” to tap banks for loans, fuelling the credit cycle. Thus, the efforts of USAID and other donors to support the development of such NBFIs demonstrate an effective approach to addressing the SME credit problem.

Regional Support Funds

Some regional and local government administrations in regions that the team visited have mechanisms through which they provide credit to SMEs. These credit programs are sometimes funded partly with federal support and partly with local money (such as Chita Oblast’s fund); others are comprised entirely of local money. The total sums available range from under one million rubles (U.S.\$32,000) to 40 million rubles (\$1.3 million) in Yuzhno-Sakhalinsk. Credit terms vary, although below market (subsidized) rates are common. In Blagoveshchensk the administration utilizes a non-profit institution – rather than a government office – to make decisions, although government involvement was clearly present. That program has managed to obtain funding from private entrepreneurs to supplement government budgetary allocations. (The Blagoveshchensk administration has also started a business incubator for SMEs.)

Regional support funds help address the credit needs of SMEs. However, these funds are plagued by two key drawbacks:

- **Political motivations:** Often the SMEs that receive support from the regional support fund are politically well-connected. Those SMEs that do not have connections with the regional administration and/or with the regional support fund’s decision-makers often have a difficult time securing assistance from regional support funds.
- **Poor financial management:** Granting a government entity discretionary control over capital for lending is both an invitation to favoritism and to mismanagement. Government agencies rarely have the necessary skills or experience to effectively

manage credit programs. The Ulan-Ude regional support fund, for example, went bankrupt in 2001, following a series of defaulted loans.

Some regional support funds have received donor assistance. For example, the Eurasia Foundation and TACIS assisted the Chita Oblast fund to develop a small BSI to provide training and to help SMEs develop business plans. Overall, though, the assessment team believes that donor efforts would be best targeted toward non-government mechanisms that aim to become self-sustaining, rather than government entities that are subject to political pressures and likely to be dependent on continuing government subsidies.

Leasing

Leasing is an infant industry throughout Russia and in the RFE in particular that has the potential to significantly boost SMEs. The key hurdle is that many small- and medium-sized companies cannot gather sufficient cash to make the required up-front payment (roughly 25% of the total value of the leased good) to enter into a leasing agreement.

DeltaLease-FE, a TUSRIF-supported company, is an important player in the industry, with outstanding leasing financing agreements worth \$4.6 million. Geographically, 30% of the company's clients are in Khabarovsk, 45% are in Primorski Krai, and the balance are in Sakhalinskaya Oblast. DeltaLease-FE reports that roughly 70% of its customers are SMEs, although supporting SMEs per se is not an explicit mandate of the company.

The assessment team also learned of a number of private, non-donor related leasing companies that were either operational or in the start-up stages of development. It is unclear how these companies will evolve and how they will compete with DeltaLease-FE. The expansion of leasing into currently unserved areas would expand the potential of SMEs in those localities.

Other Opportunities

Two other opportunities in the credit arena are to provide sources of start-up capital and to supply venture capital. In the present environment, it is likely that start-up capital will remain constrained to informal sources. Even in developed economies, bank funding for start-ups is unusual.

Venture capital is highly developed in parts of Russia, but it is generally not available in the RFE (bar a donor-sponsored fund that is presently liquidating). None of the team's interviewees mentioned venture capital as an option that was available. Although USAID/Russia has provided funding in the past for venture capital (e.g., through TUSRIF), those efforts do not appear to have resulted in much activity in the RFE. To address these gaps, the creation of new financial mechanisms, such as a venture capital fund focused on SMEs, would contribute to SME development in the region.

E. Business Skills

Background

One of the many intriguing questions about today's Russia is where have all the businesspeople come from? Given that the Soviet government essentially suppressed the market and ran its state "businesses" on non-market principles, how have so many Russians been able to start and successfully manage SMEs in the RFE and throughout Russia? How important have business training programs been in preparing Russia's successful entrepreneurs and business managers?

The assessment team posits that the answers to these questions lie partially in the following factors:

- ***In the early stages of the economic transition, the economy was unusually forgiving of errors.*** During the late Soviet period and in the early part of the last decade, the supply of goods and services was very limited. Consumers were happy to get almost anything. There was little quality or price competition. These conditions meant that new entrepreneurs were not under great pressure to be efficient, to offer good quality, to meet deadlines, and to provide customer service. Thus, the environment afforded them an unusual opportunity to learn through experience.
- ***Russian entrepreneurs are smart, willing to take large risks and very well educated.*** The assessment team interviewed numerous businesspeople and found that a large percentage were former academics. With no formal business training, these people embarked on business careers and found ways to be successful.
- ***Business training programs have sprung up to provide basic business skills training.*** Russians have taken the initiative in cities across the country to develop business training institutions, some affiliated with state educational institutions and others totally independent. As noted in Section II, the Morozov program unites a group of some 70 of these institutions. Donors, particularly USAID, have created a myriad of programs to support these training activities. In the RFE, USAID-assisted business support institutions (including those assisted under the ARC, Morozov, IRIS and EBS programs) have provided at least basic business skills training to thousands of Russians.

The environment for SMEs has now changed somewhat. Competition is far greater, perhaps eliminating the advantage given to early entrants into the market. With respect to business skills training, there are a considerable number of training providers and opportunities to learn business skills on the job. Business training providers indicate that they are adjusting to the demand for more sophisticated training. They report considerable demand for their courses.

When queried about constraints to SME growth, businesspeople and government leaders interviewed for this study almost never identified a lack of business skills as an important consideration.

Obstacles

To some extent, the quantity and quality of business training appears to be a constraint. With respect to quality, the key issue is finding Russians with practical business experience that are willing to teach. Most successful businesspeople in Russia are relatively young and fully committed professionally to their businesses. Thus, there are few Russians with anything like the experience of the Americans who have come to Russia under the EBS and ARC programs. At the same time, some interviewees noted that Americans face a serious handicap as trainers in their inability to communicate in Russian and their lack of knowledge of local business realities.

Some interviewees also criticized existing training programs as focusing too much on basic business skills and not offering an adequate range of more advanced courses. The dearth of such courses may be caused by a shortage of people competent to teach those subjects, or, perhaps more likely, the demand for those programs is limited.

Although the evidence is somewhat mixed, the team's interviews generally suggested that the demand for training courses is limited. Few businesspeople indicated that they have used training facilities or plan to do so. Training institutions provide another perspective on this issue, indicating adequate to strong demand for the courses they offer. At the same time, the demand for training at the ARC centers is not sufficient to generate revenues to cover costs, and the demand at the Blagoveshchensk BSI was not adequate to support full-time professional staff. On the other hand, the demand for the services of the BSI in Ulan-Ude is sufficient to support quite a number of full-time positions.

Opportunities

The most significant need with respect to business skills appears to occur in those locations where USAID has not been active in supporting business training programs. Additionally, the team believes that the contribution of the Junior Achievement program to the development of the next generation of business managers, entrepreneurs and leaders is likely to be significant and to make a positive long-term contribution to USAID's economic and social goals in Russia.

F. Physical Infrastructure

Background

Physical infrastructure in Russia, and in the RFE in particular, is inadequate and in poor repair. Building and maintaining the physical infrastructure to adequately connect all corners of the world's largest country – even under the best circumstances – would require massive and sustained investment. But Soviet construction standards were often low, and the subsequent lack of funding for upkeep and upgrading (to say nothing of further development) has meant that much of the basic infrastructure has deteriorated. Given the vast distances and the relatively sparse population in the RFE, the region's extensive need for infrastructure have often been underfunded.

Obstacles

Russia's limited physical infrastructure – including airports, railways, roads and ports, to hotels and commercial space – is a key constraint for SMEs throughout the country, and in the RFE in particular. The implications for SMEs in the RFE are manifold:

- **Transportation costs are high**, reducing competitiveness on all levels. One vendor of electronic goods reported that the prices he charges in his stores are some 30% above those in Moscow, due largely to transportation costs. The quality of roads – where they exist – is poor. The railway, for most RFE cities, is the most viable form of transportation, but tariffs for the Trans-Siberian railway have increased as state subsidies have been reduced, making it an uneconomical form of transport for many businesses. Air service is available to a limited menu of destinations and too expensive for most goods. Shipping, while an option for Vladivostok and Yuzhno-Sakhalinsk, is often slow and inefficient.
- Consequently, the **costs of inputs and finished goods are higher** than in other areas of Russia, **rendering exports from the RFE relatively less competitive**. Those SMEs engaged in production are faced with a small natural market and significant pricing hurdles if they try to sell outside of the immediate area.
- **Other inputs, such as power, are also relatively more expensive**. The managers of SMEs in the RFE that are large power consumers frequently complained to the assessment team about the high price of power, particularly compared with rates charged in Irkutsk and Krasnoyarsk. Power in much of the RFE costs 20-30% more than in Moscow and St. Petersburg and as much as two to four times more than in parts of Siberia.
- **Poor infrastructure raises the cost of doing business**. One effect of the state of physical infrastructure on SMEs – in the RFE in particular – is to raise barriers to entry.

Opportunities

Arguably the silver lining of poor physical infrastructure is that it forces SMEs in the RFE to cut costs and become leaner operations in other arenas – thus putting them on strong footing if/when the physical infrastructure improves. However, this is scant reassurance for the struggling entrepreneur.

There are some positive signs that market dynamics will pick up some of the slack in the RFE's physical infrastructure. Over time, market demand (perhaps assisted by selected local funding) will likely drive an improvement in the RFE's tourism and hospitality infrastructure. These sectors have already shown notable improvement in recent years. Similarly, market demand for commercial real estate has triggered a boom in real estate prices throughout the RFE. This price escalation has spawned a rash of real estate development investment project proposals in Ulan-Ude, Chita, Vladivostok and elsewhere.

There is also some evidence of infrastructure investment appearing on the agenda of both the federal and regional governments. The construction of a road linking a number of the cities in the RFE is slated to be completed in 2007-2008. Also, a proposed trans-Korean railway that would connect with the Trans-Siberian railway at Ussurisk would cut

transportation costs for Primorski and Khabarovski Krai and open up markets to less costly ground transport.

Despite the large infrastructure needs and the implications for SMEs, the assessment team believes that this is not a sector where USAID involvement is appropriate.

G. Influence of the Business Community

Background

In advanced market-based economies, the business community is typically well organized, with business associations working to influence policy-makers and regulators and serving to educate the public on behalf of the business interests. Effective business associations also encourage government transparency, competition in procurement and foster the development of civil society.

The role of such associations in Russia is far more limited. In the RFE, the number, quality and strength of business associations varies, with most associations having very limited geographic scope, loosely organized and only marginally effective in representing the interests of SMEs. Seldom did the assessment team find broad-based and articulate associations, influential in advancing positions on behalf of their membership. Among the cities that the assessment team visited, Khabarovsk enjoys the most effective business organizations (including a number of women's professional organizations⁵), and officials in Khabarovsk claim to work closely with those organizations in shaping public policy and programs. Vladivostok boasts numerous associations mostly organized by industry. In contrast, the assessment team found little evidence of strong associations in Sakhalinskaya Oblast, a situation typical of the other cities that the team visited.

USAID/Russia's current strategy (Strategy Amendment, February 2002) identifies the need to strengthen business associations. At the national level, USAID support to the CIPE program (see Section III.A) works to organize regional chamber of commerce throughout Russia. Its on-going efforts have resulted in the formation of a number of regional associations whose goals include fostering local organizations. CIPE is currently engaged in efforts to organize Chambers of Commerce in the RFE, and a conference toward that end is scheduled for Spring 2003.

In the past, USAID financed the Sakhalin Business Association Extension project. The final report for that project (May 2000) notes that a Sakhalin Chamber of Commerce and Industry and a Sakhalin Union of Entrepreneurs and Manufacturers were organized by the time the project ended, but that neither had developed strength at that point. The team's interviews with businesspeople and officials in Yuzhno-Sakhalinsk indicated only limited awareness of either organization.

⁵ These associations include, for example, the Khabarovsk Regional Producers and Entrepreneurs Association, the Association of Fish Producers and Fish Exporters of Khabarovsk Krai, the Association of Meat Processing Enterprises, the Far East Union of Woodworkers, the Far Eastern Association of Realtors, and the Far Eastern Association of Producers of Non-timber Forest Products. Women's groups include the Union of Businesswomen and the Municipal Union of Businesswomen.

Obstacles

The CIPE program reports that it has been quite difficult to organize regional associations in the RFE. This difficulty is attributable in part to its distance from Western Russia. CIPE has also noted that businesspeople in the RFE tend to be resistant to joining such associations, preferring instead to handle their problems individually.

Lingering public sector suspicion about free enterprise – although diminishing – is still evident. This attitude manifests itself in various ways – in excessive regulation, in a reluctance to include business in discussions of public policy issues and sometimes in efforts to usurp the independence of business associations. In contrast, more progressive officials often encourage the development of strong, independent organizations, seeing them as potential allies in their efforts to carry out economic and social programs. Unfortunately, the team heard of only a few instances of the latter.

Opportunities

Efforts utilizing already successful Russian business associations would appear to provide the most cost-effective method for developing and strengthening other business associations. USAID might also consider using U.S. business associations that could employ networking, partnering and mentoring approaches and perhaps develop long-term relationships that would continue after USAID financing ceases. Small grants would likely be effective in helping associations to initiate new services.

Programs that operate nationally such as CIPE deserve continued support in organizing and developing business associations at the regional level and strengthening the national associations. Other efforts to provide credible, analytic information about the condition of SMEs and their environment (e.g., CEFIR) should continue to be supported.

V. Findings: SME Potential in Selected Sectors

This section provides the assessment team's views on the potential for SME development in five sectors: timber processing, non-timber forest products, oil and gas, fisheries, and ecotourism.

A. Timber Processing

Background

The timber industry historically has been central to the economies of the RFE. Together these regions account for more than half of Russia's total forest acreage. However, by the early 1990s Russia's economic and political turmoil began to take their toll on the timber industry, lowering investment and output. The total timber harvest in Khabarovsk Krai, for example, fell from nearly 14 million cubic meters in 1989 to less than five million cubic meters per year in 2001.

The relatively high quality of the forests allows for the production of a wide spectrum of processed wood goods. However, the potential for secondary wood processing (SWP) has been little realized.

Obstacles to the growth of SMEs

While a small number of politically well-connected firms have continued to dominate much of the industry, SMEs have slowly evolved to fill in gaps, particularly in secondary wood processing (SWP). These companies have been constrained by several factors:

- Credit and investment is largely unavailable for companies in the sector. One consulting company the assessment team interviewed mentioned an SWP firm that was unable to fill an order from a German client because it had been unable to purchase the appropriate drying and packaging equipment,
- Dearth of qualified personnel to introduce recent SWP technology;
- High energy costs;
- Underdeveloped transportation infrastructure, and consequent high transportation costs;
- Small local markets, and insufficient information about foreign markets;
- The domination of large harvesting companies that achieve economies of scale, which are difficult for SMEs to compete with; and
- Environmental problems, such as forest fires, that harm the quality of the forest and timber products.

The fact that as much as 80-90% of the RFE's harvested timber is exported as logs, primarily to China and Japan, without further processing in Russia represents a significant loss for local producers and the economy of the region. The present taxation environment, according to a number of industry participants with which the assessment team spoke, does not encourage timber processing. This problem will need to be addressed at the federal level.

Opportunities

Despite these obstacles, the past two years has seen a recovery of sorts in the industry. The assessment team was told about increased support by local governments and increasing interest on the part of SMEs in developing SWP operations. The number of forest product companies in Khabarovsky Krai increased in 2001 by 150% to a total of 400. Additionally, the low level of harvesting relative to the total permissible harvest (in Chita oblast, only 10% of the total cut allowed by government regulations is actually harvested) suggests significant potential for growth. Another encouraging factor is that Russia's economic growth is providing consumers with increased disposable income, and that additional income has generated significant demand for building construction and renovation. This has indirectly fueled demand for SWP goods. The assessment team visited a number of SMEs that said they are hoping to develop wood processing activities that will meet international standards of quality and allow them to export.

USAID (through the FOREST project) and the World Bank are currently supporting a variety of efforts to tackle the industry's problems, from encouraging conservation to assisting SMEs engaged in secondary wood processing. Given competing demands for meager resources, the assessment team sees little scope for USAID to increase its activity in the sector.

B. Non-Timber Forest Products

Background

The RFE is rich in NTFP resources, thanks to the area's relative ecological purity, small population, and exceptional biodiversity. This potential remains largely untapped. The collapse of the Soviet-era system of collection and distribution of NTFP goods led to the disintegration of the industry's infrastructure during the 1990s. Subsequent and ongoing donor assistance has helped reconstruct components of the sector, assisting producers with market analysis and business plan development and promoting industry associations to advocate the interests of producers.

Obstacles to the growth of SMEs

The NTFP industry, by its nature, is composed of a large number of SMEs spread over remote areas. Aside from the expected collection/production problems associated with harvesting natural products in a harsh environment, the industry faces a number of obstacles:

- Absence of a set of well organized and integrated distribution channels
- Poorly organized and executed marketing activities
- Weak institutional support – the reach of industry associations is not yet as strong as it needs to be
- A dearth of processing operations which leads to high levels of exports of unprocessed goods
- Lack of credit availability to purchase new equipment
- Deficit of trained specialists and specialized training relevant to the NTFP sector
- Administrative barriers, in the form of certificates needed for export, licenses for harvest, etc.

Opportunities

The NTFP also enjoys several advantages over many other industries. Assuming that products are harvested in an ecologically friendly and sustainable manner, NTFP products are naturally renewable. Entry is facilitated by the fact that needed up-front investment is usually modest. Further, the demand for NTFP goods is large and growing. At this time, however, it appears that producers in the RFE do not have adequate communications, distribution or marketing channels.

USAID is responding to the needs of the needs of this sector through the FOREST project. FOREST is helping to develop industry associations, assisting producers to create marketing programs and business plans, undertaking market research and analysis, and providing short-term technical and marketing specialists. One possible additional area of future support could be a targeted microfinance program for NTFPs.

C. Oil and Gas Production

Large deposits of oil and gas were confirmed off the coast of Sakhalin Island at the beginning of the last decade. The Russian Government has granted the rights to develop these deposits to two international consortia: Exxon-Neftegaz Ltd. and Sakhalin Energy.⁶ Both production companies on Sakhalin are very large, vertically integrated enterprises. Each will fully control every step of the development of its sites and the extraction and transport of its product.

Large natural resource development contracts between governments and foreign firms often require that those firms utilize local firms and labor and contribute to social and economic development activities that go well beyond their direct business activities. In the case of the two investment programs on Sakhalin Island, the agreements require that the international consortia commit to their “best efforts” to utilize local companies and resources – referred to as “Russian Content,” but the companies are not legally bound to do so. It is unlikely that these conditions will lead to any meaningful role of Russian SMEs in oil and gas production.

Sizeable infrastructure construction projects for the extraction and transport of the product will be required. Construction activities will include drilling, roads and railroads, ports, crude oil and gas pipelines, and energy production, storage and supply. To date, contracts have been let with large international and Russian firms for these purposes. The prospect for SMEs to participate in this construction is very limited.

The development of these large scale investments will generate demand for many products and services (e.g., local transportation, food services, security services) that SMEs produce and sell. However, observers in the Sakhalin area believe that the oil and gas industries will prefer to develop their own in-house capacity, thereby minimizing

⁶ The RFE also has an oil refinery located in Khabarovsk Krai at Komsomolsk-na-Amur. This refinery receives crude from central Siberia. The product from this refinery has traditionally been for export or to supply the military and large state industries in the RFE.

dependence on local firms. In some cases, the international groups may develop their capacity by simply buying-out the local SME producer(s). Thus, the oil and gas investments are not likely to lead directly to new opportunities for SME growth.

That said, these very large investment programs will set off an economic boom, and the economies of the region will benefit in proportion to their proximity to Sakhalin Island. Employment, wages and disposable income will increase, perhaps dramatically. Increased disposable income will lead to a considerable increase in demand for many of the goods and services that local SMEs offer.

The scale of the investment and the power of the actors involved in this sector are such that the assessment team sees little prospect for USAID to influence either the limited direct effect on SMEs or the very substantial indirect effect that are likely to occur. Therefore, no intervention to stimulate SME growth related to the oil and gas sector or, for that matter, in Sakhalinskaya Oblast, is recommended.

D. Fisheries

Background

Most RFE fish catching and processing is carried out in four regions: Primorski Krai (49%); Kamchatskaya Oblast (25%); Sakhalinskaya Oblast (16%), and Khabarovski Krai (7%). As of 1996 (most current available data⁷) the industry still provided a sizeable proportion of the total market output of these regions:

Primorski Krai	34% (out of 14.3 trillion rubles)
Kamchatskaya Oblast	75% (out of 4.6 trillion rubles) – 62% in 2001
Sakhalinskaya Oblast	47% (out of 4.8 trillion rubles)
Khabarovski Krai	20% (out of 12.3 trillion rubles)

A legacy of the Soviet system is an academic complex in Vladivostok that serves the needs of the fishing industry and the merchant fleet. This complex provides training and research related to the industry.

Major changes have occurred in this industry since the Soviet era when it was a huge fleet-based operation with cannery and transport ships, extensive on-shore processing, well maintained port facilities and seemingly unlimited supplies of fish and domestic demand. The fish product now reaching Russian ports for handling is diminishing because nearby waters are less productive; there is less fleet capacity to reach distant, more productive waters, and much of the catch is sold directly to foreign importers (making recent data about the catch questionable). The RFE on-shore processing and maintenance infrastructure – including ports - has aged and decayed.

Constraints to the Growth of the SMEs

The industry is dominated by several major firms, most notably Dalmoreproduct in Vladivostok. Most of the larger fishing enterprises are established as joint stock companies or organized into associations. Major firms typically harvest, process,

⁷ www.businessstime.ru

package, and sell their own products. Many smaller firms, usually lacking processing capabilities, are organized into regional fishing "kolkhozes" (collectives). These, in turn, are united into regional fishing-kolkhoz unions ("Rybakkholkhozsoyuzy").

Entry into the fishing industry is limited by the existing ownership and the high capital costs needed to achieve the economies of scale necessary for profitability. Sole proprietors and very small firms are involved with shallow water fishing and shellfish harvesting, which have far, lower capital requirements. However, this constitutes a very small portion of the industry, and the prospects for growth are quite limited.

Opportunities

In sum, the RFE's fishing industry is well established and largely in the hands of large firms. Given the difficulty and high cost of entry, the industry offers few opportunities for SME growth.

E. Ecotourism

Background

The RFE is endowed with vast untouched expanses of nature that have considerable potential for ecotourism. The region has 18 nature reserves, each with unique ecological, geographic and cultural features. It also boasts of wildlife refuge areas and regional national parks intended to host tourists. The Lake Baikal area, home to nearly a fifth of the world's supply of fresh water, is similarly rich in opportunities for ecotourism (see Appendix 7.). But while the potential for ecotourism in the RFE is considerable, converting potential into reality will require significant investment.

Obstacles to SME growth

The key obstacle to the development of ecotourism – for SMEs or businesses of any other size – in the RFE is the poor state of tourism infrastructure, most notably transportation and hospitality facilities. The tourism industry has not developed in the RFE, and until the infrastructure exists for tourism, ecotourism will struggle to broaden its appeal beyond the hardiest travelers who are not discouraged by poor transportation and accommodation facilities. One businessman in Khabarovsk commented, "Until any visitor can move without delays from an airport to a comfortable hotel or any other place of interest, ecotourism will not develop here."

On another front, the legal environment for tourism has not been established, meaning that entrepreneurs need to create new legal precedents as they go. One would-be investor in riverbank development balked at the complete absence of legislation addressing the issue, which he believed would be a significant obstacle to his investment plans. The legislative infrastructure for the sustainable development of national parks and special ecotourism areas is similarly underdeveloped, exposing potential investors of every size to significant risks.

Opportunities

A wide spectrum of government officials and businesspeople interviewed by the assessment team spoke cited ecotourism as one of the key hopes for future SME growth in the RFE, suggesting that momentum for developing the field is slowly mounting. Local administrations in a few areas have assisted the young industry by publishing guidebooks, supporting tourism agencies, and making small investments in tourism infrastructure.

Ecotourism development will need to confront the problem of the lack of transportation and accommodation infrastructure, even though the comfort levels required by ecotourists are typically modest. Indeed, even with the present poor infrastructure, many ecotourists who go to the RFE enjoy the experience; the head of the Interregional Association of Independent Tour Operators of the RFE estimated that as many as 80% of first-time visitors return.

USAID-supported programs through the World Wildlife Fund (WWF) and the Institute for Sustainable Communities (ISC) have encouraged the growth of an ecotourism industry in the RFE. These programs have been helping develop bed and breakfasts, training tour guides, supporting small businesses along trails, building a local marketing capacity, and helping develop links between RFE and U.S. tour operators. A lack of funding, however, resulted in the termination of WWF activities.

The assessment team believes that any substantial future USAID investment in ecotourism development needs to be preceded by an appropriate market study. (See Section VI.B.4.)

F. Other Industries

Sections A through F above assess the potential for SME development in the five sectors specified in the team's scope of work. In addition, the assessment team attempted in its interviews and reading to learn about SME potential in other sectors. The team noted significant growth potential in construction, furniture production, retail trade, tourism and clothing production. Appendix 6 provides a discussion of the team's findings.

VI. Conclusions and Recommendations

This section is divided into two major subsections, one dealing with cross-cutting conclusions and recommendations and the other with conclusions and recommendations regarding alternative foci for a USAID SME development strategy in the RFE.

A. General Conclusions and Recommendations

1. General Conclusions

- ***The rapid growth of the SME sector in the Russian Far East suggests that Russian entrepreneurs, although lacking in business experience, are adept at overcoming the many obstacles they confront as entrepreneurs.*** The number and variety of SMEs in the RFE has grown dramatically over the past decade, albeit from a miniscule base. Some of these firms are privatized businesses that existed during the Soviet era, although often in a very different form. Most, however, did not exist a dozen years ago. When one considers the obstacles -- the lack of business experience and skills that existed at that time, the lack of credit, government policies and regulations that continue to create obstacles to business, the financial crisis of 1998 and a variety of other factors, this Russian achievement is quite remarkable.
- ***Increased competition among SMEs is creating predictable market responses: higher quality, more variety, lower prices and better service.*** In comparison with the Soviet era, consumers in the RFE are clearly getting a broader choice of better quality consumer goods. Additionally, consumers are benefiting from better service; the surly and indifferent attitudes of those dealing with the public are being replaced with more service-oriented and customer-friendly attitudes. These trends toward more competition, better products and better services are likely to continue.
- ***The increased competition in sectors where SMEs are concentrated may slow the growth of SMEs and move future SME investment toward new industries.*** The great majority of the SMEs in the RFE are involved in retail trade and services. This reflects, first, considerable demand in these sectors, and, second, the fact that such enterprises typically do not require sophisticated technical knowledge or large amounts of start-up capital, making entry relatively easy. However, increased competition in those sectors will make new entry and sustainability more difficult, limiting SME expansion in those industries and pushing future growth into other industries.
- ***USAID and other donors' activities have spawned business support services that have contributed to the growth of the SME sector.*** Considerable anecdotal evidence suggests that business training programs provided knowledge and skills to individuals that were useful in their business activities. Fostering alternative sources of credit has not only capitalized hundreds of businesses but also has demonstrated the potential profitability in SME loans and helped to attract banks to this type of lending.

- ***Currently, the most serious constraints to SME development (that are amenable to change) are the lack of credit and the policy and regulatory environment.*** Easing these constraints would allow much greater expansion of SMEs over the near term.
- ***There are geographic disparities in the availability of SME support services such as credit and training.*** The larger urban centers (Vladivostok and Khabarovsk) have a much greater array of services to assist the SME sector. The pattern of service in other areas is varied. Blagoveshchensk, for example, has a bank that is heavily involved in lending to SMEs and Ulan-Ude has a highly developed business support organization that provides training and consulting services. Even within the Khabarovski and Primorski Krai and the Sakhalinskaya Oblast there are inadequately served areas.
- ***Available data suggest that women are not equally represented in SME management.*** Russia-wide, labor force participation rates for women are highest at lower skilled positions and lowest at senior management levels. However, women appear to be well represented in USAID programs, e.g., as credit recipients.

2. General Recommendations

- ***Continue to support SME development in the RFE.*** USAID's rationale for this assistance remains valid, and experience has demonstrated that USAID SME development programs are effective.
- ***Focus interventions on improving access to credit and, where opportunities present themselves, on improving the policy and regulatory environment.*** Such investments would address key constraints to SME growth.
- ***Focus interventions on relatively underserved communities.*** This recommendation, the assessment team appreciates, must be considered in the context of USAID's regional priorities. Underserved areas include much of the RFE other than the principle urban centers: Vladivostok, Khabarovsk, Yuzhno-Sakhalinsk and Magadan.

B. Conclusions and Recommendations on Specific Strategies

The team's conclusions and recommendations are grouped around the four principal intervention strategies identified in Section III to describe previous USAID interventions:

- Improving business skills
- Expanding credit availability
- Improving the policy and regulatory environment for SMEs
- Exploiting opportunities in selected sectors

These strategies or programming categories are not mutually exclusive, and within each of these broad areas there are, of course, numerous programming options. The assessment team's conclusions and recommendations with regard to each of these categories are provided in the following subsections, including a final subsection that provides a prioritization of the team's recommendations.

1. Developing Business Skills

Conclusions

- ***Although there are disparities within the region, business training is available and generally adequate to meet current needs of SMEs.*** The assessment team’s interviewees revealed little indication of training or consulting demand that could not be met through current institutions. Not surprisingly, larger urban centers are better served than smaller, more remote areas. Although many of the training organizations are small and function at a modest level, with the exception of the ARC centers they seem to be financially self-sustaining. Because of the newness of the business sector in Russia, trainers often lack the level of practical experience that would be desirable, and this does impact to some extent on the quality of the training and consulting offered.
- ***USAID has played a very positive role in the development of the region’s business skills training institutions.*** USAID’s support through a variety of business training programs has helped to introduce the idea of business training in the RFE and to build Russian training institutions.
- ***USAID’s resources devoted to developing business skills in the RFE is currently allocated largely to the ARC program – a high quality program that should be operating independently with a minimum of external financing.*** In contrast to its other BSI-development programs, USAID’s ARC program has focused more on directly providing business training and correspondingly less on institutional development. Although the ARC program has gradually reduced its use of American experts to provide training directly to Russians and has given more attention to self-sufficiency, it continues after nine years of operations to utilize Americans to teach some of the courses in the RFE, to run an advanced version of its basic business training program in Anchorage, and to train business trainers in Anchorage. ARC’s continuing reliance on American teachers and U.S.-based instruction greatly inflates costs and contributes to this program’s difficulty in achieving self-sufficiency. A second major difference between the ARC and other BSI-support programs occurs in the area of governance. In all of its BSI-support activities other than ARC, the role of USAID’s grantee is to provide technical assistance, training and (in some cases) teaching materials to independent Russian entities. In contrast, ARC exercises direct supervisory and financial control over the training centers it has created. In the assessment team’s view, the local institutions’ high degree of dependency on the grantee (particularly after so many years of operation) is highly unusual and not conducive to the development of robust, sustainable Russian business training.
- ***While many Russian business training institutions would benefit from continued USAID assistance, the return on such investments is declining.*** There is now a cadre of Russian business trainers, particularly in the more heavily populated areas, who have a base of expertise and training experience. This cadre of trainers will grow and improve in quality as they gain additional experience. Although further USAID investment in this

level of business training (e.g., in the training of trainers as is being offered through EBS in other parts of Russia and through ARC in the RFE) would be useful, it is not essential. The key constraint on the growth and effective utilization of business training may now be more on the demand side.⁸

- ***Junior Achievement offers a cost-effective method of preparing the next generation of Russians to understand the workings of and participate in a market economy.*** JA is helping millions of Russian youths to understand market economics, and it encourages the development of attitudes and skills conducive to enterprise development and growth.
- ***There is limited availability of high-level business training, research on business issues or intellectual leadership within the private sector.*** The dialogue on business issues tends to be dominated by the oligarchs, firms involved in natural resource exploitation and other large firms that grew up in the Soviet era. Although small and medium-sized businesses have mushroomed and become economically important, the business associations, think tanks and university programs that often highlight their issues are underdeveloped in Russia, and particularly in the RFE.

Recommendations

- ***Limit future investment in basic level business education.*** With diminishing financial resources available to USAID/Russia and many BSIs reasonably able to respond to current levels of demand, the case for continued assistance to BSIs has diminished. USAID's limited funding would yield greater results invested in programs to address credit and policy and regulatory constraints and other types of business education needs.
- ***Shifting resources from business training to other strategic areas implies a need for USAID to end financing for the ARC program.*** The assessment team suggests that any extension of the ARC grant be time limited (perhaps to 12-18 months) and focused on training trainers for the three ARC centers and, resources permitting, for trainers in other BSIs that have cooperated with the ARC centers. In implementing that program element, USAID should expect ARC to seek experienced Russians to provide the training, and that training should be provided in Russia.

⁸ Evidence supporting this conclusion includes, for example, the experience of the formerly USAID-assisted BSI in Blagoveshchensk. Despite its participation in the EBS program (which the principals of that institution rate very highly), it has been unable to generate sufficient demand to employ more than one junior staff member on a full-time basis. Certainly its seminars and consulting are playing a constructive role, and USAID-assisted programs helped to make that possible. The point, however, is that the institution's capacity to provide training and consulting services exceeds the demand. Were this not the case, those who have been trained would be working full time in delivering such services. The difficulty that the ARC program has experienced generating sufficient revenue to cover its costs could be evidence again of limited demand, at least at prices sufficient to cover costs. Although regional and local governments may decide to subsidize business training, gradually market forces must be allowed to determine the size and nature of these services.

▪ ***Should the Mission decide to continue assistance for basic business skills development, focus on cost-effective methods to upgrade training and consulting of existing Russian BSIs.*** Notwithstanding these recommendations, the assessment team recognizes that the Mission may wish to continue some broader form of assistance to BSIs. If this is the case, the assessment team has several suggestions about how this might best be done. First, the team views the IBS program⁹ as a cost-effective approach to providing enhanced skills to a variety of BSIs. Particularly laudable are that program's increased emphasis (as compared to EBS and other predecessor programs) on improving the capacity of participating Russian BSIs and enhancing their financial sustainability. If the Mission decides to extend that beyond its current grant period, the team recommends that RFE institutions be included.

Nevertheless, the Mission might consider an alternative mechanism aimed at developing some type of long-term linkage between Russian and U.S. business support organizations. Such a mechanism, particularly if developed with organizations in Alaska, the Pacific Northwest and California, would contribute to the ties between Russia and the United States and would create a mechanism for continued sharing of business expertise and materials. Such a program would be consistent with the emphasis on partnerships and linkages articulated in USAID/Russia's Amended Strategy. The team envisages a USAID program that would provide a small amount of seed capital to organizations able to demonstrate interest in forming such partnerships. The bulk of funding for such partnerships would thus need to come from private sources.

▪ ***Continue support to Junior Achievement.*** Ultimately, much of the future of Russia's economic growth – and SME development – will depend upon the attitudes and knowledge of Russia's younger generations about the market economy and entrepreneurship. Support for the Junior Achievement program is a long-term investment that will help plant the seeds for future generations of entrepreneurs. There is no other program currently available in the Russian public school system that teaches these values and skills.

▪ ***Consider the development of a U.S.-style university-based business school in the RFE.*** USAID experience in other regions (e.g., INCAE in Central America) has demonstrated that U.S.-style business schools can have an enormous development impact. The core of such programs is typically the masters degree program in business administration (MBA), with a variety of other associated programs and activities – short courses and seminars open to all, advanced management programs for middle and senior level businesspeople, short courses tailored for specific businesses or industries, consulting for business and government; dissemination of research finding to business, policy-makers and to the public; the development of curriculum and teaching materials for other universities, schools and BSIs, and the education of business leaders about key business values and ethics. Thus, the role of such an institution would be not only to teach business skills but to teach business ethics and to provide intellectual leadership for the business sector, to influence government policy and regulation, to prepare future

⁹ The assessment team met with the CDC project manager in Moscow, reviewed several IBS documents and is familiar with the IBS (which the assessment team did not have the opportunity to observe directly).

university business faculty, to training consultants and trainers for BSIs across the regions.

2. Improving Access to Credit

Conclusions

- ***Access to affordable credit remains one of the most serious obstacles to SME growth in the RFE.*** Although progress is being made in developing a market-based system of banking and non-banking financial institutions to serve SMEs, credit availability remains one of the most serious obstacles to SME growth in the RFE. Current sources are said to provide only a small percentage of the potential demand for loans to SMEs.
- ***Donor programs that work intensively with selected banks, providing them with credit and technical assistance, are an effective method to develop credit institutions for SME clients.*** The bottom-up approach to reforming the banking sector that the EBRD program is utilizing seems to be very productive and should certainly be continued.
- ***Donor-assisted MFI programs are filling an important credit gap, providing resources to viable firms that lack access to bank credit.*** Creating an effective banking system is the best way to resolve the credit problems faced by SMEs. However, the short-term prospects for making the needed changes are not encouraging.
- ***Venture capital is generally not available in the RFE, but could contribute to SME development.*** As indicated in Section IV.D above, few if any venture capital funds operate in the RFE. This is regrettable, as the demand for venture capital investment in the RFE is potentially very large; many well-managed businesses that presently seek to attract bank financing might avail themselves of the opportunity to obtain funding from venture capital investors. Importantly, in the medium term venture capital is typically less costly; it should thus provide an attractive option for businesses seeking to expand.

Recommendations

- ***Support the expansion of lending to SMEs by commercial banks.*** To the extent that it is within the brief of the Mission, the assessment team favors the continued support of the efforts of the EBRD Russia Small Business Fund, and of KMB Bank, which is partly funded by the EBRD.
- ***Support the development of microfinance in underserved RFE markets.*** The assessment team believes that the Mission should consider increasing its focus on helping create micro-finance institutions in the most underserved areas. To contain costs while increasing the chances for sustainability, USAID might explore the use of experienced Russian MFI managers (e.g., from Vladivostok and Khabarovsk) to manage new MFIs, rather than bringing in foreign consultants to lead the projects.

- ***Encourage the availability of leasing programs in underserved areas.*** USAID assistance should be targeted at geographic areas where market forces have not yet been effective in bringing forth new financing mechanisms. Thus, new support for a program like DeltaLease-FE – which indirectly uses subsidized capital and thus enjoys an artificial advantage over leasing companies that do not receive donor assistance – should be focused on geographic areas (unlike Khabarovsk and Vladivostok) where leasing has not yet taken hold.

- ***Consider sponsoring the creation of a venture capital fund focused on SMEs in the RFE.***

The assessment team recommends that the Mission determine the viability of and consider participating in a venture capital fund that would invest in SMEs in the RFE, either in partnership with a private venture capital fund or via existing donor-supported venture capital activities (such as the EBRD and TUSRIF). Such a fund would focus on investment in small and (particularly, given investment economies of scale) medium-sized firms.

3. Improving Government Policy and Regulation

Conclusions

- ***Problems in the policy and regulatory environment remain a primary obstacle to SME development in the RFE.*** (See Section IV. C. “The Policy & Regulatory Environment.”)

- ***SME business associations are typically localized, not well organized and have limited influence.*** At the national level and frequently at the regional and local level, SMEs lack effective organizations to lobby for their interests. As a result, policies intended to improve the situation for SMEs sometimes have the opposite effect. Helping SMEs have a stronger role in the formulation of public policy and programs will allow government entities to have a better understanding of SME problems, create a better environment for SMEs, and encourage the development of civil society.

- ***USAID’s current strategy to build business associations at the regional level to improve the policy and regulatory environment (implemented through the Mission’s grant to CIPE under the SME Policy Reform project) is based on a realistic assessment of what is possible in Russia and has significant potential to aid SME development.*** Despite the recent enactment of several significant reforms favoring SMEs, experience has shown that USAID and other donors programs have limited potential to influence the development and implementation of federal-level policy reform. Since many key government decisions affecting SMEs are made at the regional and local levels, USAID’s efforts at those levels are appropriate. Russian business associations and chambers would also benefit from the establishment of long-term linkages with similar organizations in the U.S.

▪ ***Provision of relevant information and analyses has a very positive impact.*** Programs that provide useful data and credible analyses to the SME community, the government and the general public can have a very positive impact on policy and regulation. For example, the CEFIR report on Administrative Barriers, the Observatory Report and others clearly aid in shaping public perceptions and policy in areas relevant to SMEs.

Recommendations

▪ ***Continue (and possibly expand) support of existing programs that help to inform the decision-making process and the public with respect to SME issues.*** The assessment team sees considerable merit in and encourages continuation of (a) the Mission's planned assistance to continue the CEFIR studies of administrative barriers; (b) e-Government Competence; (c) assistance to create Russian economic think tanks and to orient their studies toward priority issues involving the private sector; (d) FSVC efforts to improve Central Bank performance, particularly its role in commercial bank supervision, and (e) CIPE efforts to foster regional Chambers of Commerce. The assessment team encourages strong Mission support (such as it is giving in its support for think tanks) for efforts to disseminate information coming from these programs to the public as well as to government officials. The team recommends that USAID also encourage appropriate organizations to periodically update the SME Observatory Report and IPSSA's SME survey.

▪ ***Continue to strengthen business associations through CIPE and through interchanges, networking, partnering and mentoring Russian business associations with U.S. associations.***

4. Exploiting Opportunities in Key Sectors or Geographic Areas

Conclusions

▪ ***The most promising sectors appear to be timber processing and non-timber forest products -- the sectors in which USAID is already involved through the FOREST project.*** The FOREST project is pursuing valid strategies to promote SME development in those industries.

▪ ***The opportunities for SME growth in the oil and gas and fisheries industries are not promising.*** The assessment team does not see the opportunity for productive USAID interventions in these sectors.

▪ ***Ecotourism resources are extensive and might be commercially exploited.*** Given the unique natural beauty of the RFE, ecotourism would seem to hold potential for SME growth. (See Section V. E.). Successful ecotourism programs are likely to require the development and implementation of a coordinated set of public and private sector activities. The public sector needs to manage and protect the ecological resources and to

provide access to them. The private sector would market the site, bring visitors to it, and provide lodging and other needed amenities.¹⁰

- ***Disparities are apparent in the support available to SMEs in the seven different geographic areas visited.*** The USAID strategy for the RFE should consider these disparities. This would require that the Mission broaden the geographic focus of its RFE strategy.

- ***Other sectors do not warrant specific USAID programs.*** The assessment team also attempted to identify additional sectors that might be targeted by the USAID SME development strategy. The team did identify several sectors (e.g., construction and building renovation and maintenance) that are likely to prosper in the coming years, but they will do so without special donor-assisted donor activities. (See Appendix 6.)

Recommendations

- ***Continue promoting the wood processing and non-timber forest product industries through the FOREST project.***

- ***Consider a pre-investment study to ascertain the feasibility of developing the potential for ecotourism in the RFE.*** Perhaps the first task in exploiting the region's ecotourism potential is to determine which sites have the greatest visitor potential, the environmental risks that developing that potential would entail, and the potential benefits and costs. Conducting a study of this type would require a team with a diverse set of skills and perspectives, including individuals knowledgeable about the ecological considerations, tourism marketing, travel, and accommodations. The assessment team makes this recommendation with some reservations, as (1) the level of investment may be considerable, (2) the geographic impact would be limited largely to the immediate surrounding areas, and (3) obtaining the requisite level of open and transparent collaboration between various government agencies and between government and the private sector may be difficult.

5. Priorities Among Strategies

Recognizing that this report has suggested a number of initiatives and that, for budgetary reasons, the Mission may need to make difficult choices, the assessment team offers its view of what might be first priority and second priority activities.

First priority activities:

- ***Credit.*** Lack of credit was cited as a major problem everywhere the team traveled. And, even though tens of thousands of SMEs in the RFE have managed to establish themselves and to survive in the current credit environment, interviewees also mentioned numerous delays and projects that had to be canceled. Additionally, credit, or more specifically microenterprise credit, is a type of program for which USAID has vast

¹⁰ USAID has provided assistance to successful ecotourism projects in other countries (e.g., in Ghana).

experience and unique capability. Among the abovementioned recommendations to enhance the availability of credit, the assessment team would give highest priority to efforts to expand the geographic coverage of microfinance programs and to expand bank lending to SMEs.

- ***Policy and Regulatory Reform.*** As a constraint, government policy and regulation may be as important as credit. The assessment team sees the Mission’s activities in this area as limited but well-designed to educate and influence, and thus worthy of continued support.

Second priority activities:

- ***Improving Business Skills.*** Business skills are clearly important. The key questions however, are (1) whether Russians generally require formal training to acquire these skills and (2) whether additional USAID investment in improving training capacity is needed. In considering these questions, the team has noted above that the great majority of successful Russian businesspeople interviewed appear not to have required any formal training. In addition, the existing training institutions seem capable of surviving and growing without USAID support. These factors lead the assessment team to view additional USAID investment in this area as somewhat less critical.

The team does believe, however, that there is something of a special case to be made for the Junior Achievement program and for the idea of a graduate business school. JA is akin to a basic education program in market economics and democratic pluralism. It does not address a short-term critical constraint to the growth of SMEs in the RFE, but it may have very large long-term benefits in terms of the kind of democratic, market-based society to which USAID is trying to contribute.

Similarly, the idea of creating a graduate business school for the RFE goes well beyond the short-term needs of SMEs. Such an institution, if successful, would contribute to the development of large as well as small business, to the development of a sense of business ethics, to the development of a community of business researchers and consultants and to other attributes of prosperous business community.

- ***Sector-specific Programs.*** USAID has done a good job of identifying sectors with particularly attractive growth prospects for SMEs, and efforts under the FOREST project seem well-targeted to exploit that potential. It is too early to determine whether these efforts will be successful. Ecotourism also has potential, but the exploitation of that potential will require considerable time and investment.

APPENDIX ONE

STATEMENT OF WORK

FOR A STRATEGY ASSESSMENT OF THE NEEDS OF SMALL AND MEDIUM-SIZED ENTERPRISE (SME) ACTIVITIES IN THE RUSSIAN FAR EAST (RFE)

I. ACTIVITIES TO BE ASSESSED

This assessment will examine the needs for Small and Medium Sized Enterprise (SME) technical assistance activities in the Russian Far East. These activities should contribute toward achieving the USAID/Russia Mission's Strategic Objective 1.3: Small and medium-enterprise sector strengthened and expanded and Strategic Objective 1.6. Environmental resources managed more effectively to support economic growth. The geographical focus areas of the survey should be within the USAID/Russia RFE strategic areas.

II. BACKGROUND

Development of Russia's SME sector is critical for Russia's successful transition to a free market economy since small and medium sized enterprises are recognized as the primary engine for economic growth and job creation in most free market economies. Over the past 6 years, USAID/Russia has actively promoted SME development throughout Russia. These efforts include providing direct technical assistance to small and medium sized Russian businesses through the deployment of American business volunteers, establishing and supporting business training centers, and providing assistance to SME's through a network of Russian Business Support Institutions (BSIs) located across the Russian Federation.

USAID/Russia's first SME support program in the Russian Far East began in January 1993, when the American Russian Center (ARC) of the University of Alaska established three centers in the Russian Far East to promote the concept of entrepreneurship and to support small business development. Shortly thereafter, USAID/Russia initiated the Morozov Project, expanding SME support activities across the Russian Federation through a network of 59 regional Morozov Centers, three of which are placed in the Russian Far East. Since its inception in 1994, USAID/Russia's Morozov Centers in the Russian Far East has provided assistance to more than 500 small and medium-sized businesses. Furthermore, the Morozov Project has also provided consulting services to approximately 1,000 individuals in the Russian Far East.

In addition to the ARC and Morozov Projects, US business volunteer programs have also played an important role in USAID/Russia's support strategy for the Russian SME sector in the RFE. Under the business volunteer programs, US business consultants and managers were placed with local firms and businesses throughout the Russian Far East offering individualized consulting services on a volunteer basis. Since 1997, these business volunteer programs have been managed through cooperative agreements with Citizens Democracy Corps (CDC), International Executive Services Corps (IESC), and ACDI/VOCA. To date, approximately 300 small businesses in the Russian Far East have directly benefited from the consulting services offered by these programs.

During the period from September 1998 till December 2000 Institutional Reform and the Informal Sector (IRIS) implemented the SME Network Support and Strengthening (SME-Net) Project, built on results of the previous USAID/Russia business development activities, that created business support institutions, many of which by the time the SME-Net project started, were sustainable. This activity contributed to increasing the institutional capacity of the BSIs through the grants program, which helped organizations to improve marketing of their services and find business partners through creation of web pages, and to increase client base through introduction of new services and products. With an aim toward promoting environmentally sound business development without depleting the natural resource base, for the past several years USAID has been supporting Ecotourism Efforts in the RFE. This support has been done primarily through a \$700,000 grant to the World Wildlife Fund (WWF) in Khabarovski and Primorski krais, where seven ecotourism projects were implemented to develop infrastructure, improve marketing, and partner Russian and American tour companies. The projects involved indigenous populations in ecotourism services, and provided mobile equipment for camping in remote areas. Ecotourism was also supported through the Replication of Lessons Learned (ROLL) Program, the Targeted Grants Program (both implemented by the Institute for Sustainable Communities) and through several above mentioned business development programs.

III. INFORMATION SOURCES

See attached chart (Attachment A). (Not Included).

IV. PURPOSE OF ASSESSMENT

This assessment will:

1. Describe the SME sector in the RFE generally and provide an overview of the specified regions. Discussion should include:
 - Size, market share, number of employees, percent of GDP for SMEs
 - Structure of industry sectors important for SMEs
 - Regulatory environment of SME in the RFE
 - Major obstacles and needs of SMEs in the RFE

2. Describe the donor efforts to assist SMEs in a cross-section of geographic sites in the Russian Far East (Blagoveshchensk, Chita, Khabarovsk, Magadan, Ulan-Ude, Vladivostok, Yuzhno-Sakhalinsk and Yakutsk). Comment on best practices, lessons learned and impact. Focus on USAID's and the Eurasia Foundation's efforts, but do comment on other donor programs.
3. Identify opportunities for SME growth and development in the RFE. Comment specifically on the opportunities related to oil and gas production, ecotourism, non-timber forest products, timber and fisheries.
4. Prepare specific recommendations for future activities. Recommendations should answer the following questions:
 - Of USAID/Russia's ongoing activities what would you continue? If they do continue, how should they be changed?
 - What other approaches should be considered or used?
 - How would you prioritize all recommendations?

V. ASSESSMENT METHODOLOGY

The assessment team will propose to USAID/Russia the assessment methodology. USAID/Russia will review the proposed the overall evaluation methodology. USAID expects that at a minimum the team will:

1. Review and analyze the existing statistical data (see Attachment B).
2. Interview SMEs and organizations providing support to SMEs including private and government organizations, business associations, etc.
3. Review and analyze the existing performance information for the existing activities.
4. Interview field staff of USAID, organizations implementing associated programs, including private sector organizations, and local government counterparts.
5. Conduct site visits to Khabarovsk, Vladivostok, Yakutsk, Blagoveshchensk, Chita, Ulan-Ude and Yuzhno-Sakhalinsk.

VI. SCHEDULE

Approximately eight weeks are estimated to complete this evaluation with an assumption of a five-day workweek. If necessary, a six-day workweek is authorized. A representative work schedule is indicated below, but it may be modified on mutual agreement between the outside team and the Coordinator of this assessment from USAID/Russia.

Activity	Description	Location	Approximate Dates
Evaluation team selection	Selection of a contractor and contract negotiations. Sign a contract.	Moscow	September 17 – September 20
	USAID/Russia will provide general background, program documentation and other related information (by e-mail).	Washington	September 25 – October 2
Background	Finalize evaluation schedule, review background documents, performance information, and statistical data reports, put together a list of interviews, develop survey instrument(s), if necessary, and a report structure. Finalize and discuss the methodology and the scope of work with Evaluation Coordinator (by e-mail).	Washington	October 3 - 8
Interviews	Interviews with Mission and Provider's staff, subcontractors, counterparts, NGOs, and organizations implementing affiliated programs. Discuss the structure of the final report with BDI. Review methodology and refine, if necessary. Finalize travel schedule with Evaluation Coordinator.	Russia, Moscow	October 10 – 15
Site Visits	Conduct site visits. Provide exit briefing to USAID/Russia.	Russia (regions) Moscow	October 16 – November 8 November 12
Analysis, Report	Draft a final report, conduct additional interviews, if necessary. Draft report submitted to USAID/Russia for comments. USAID/Russia reviews and comments final draft. Incorporate the comments into the report, finalize and submit to USAID/Russia.	Washington	November 15-26 November 27 November 27 - December 6 December 9-11

The final report is expected to be submitted to USAID no later than December 12, 2002.

VII. REPORTING AND DISSEMINATION REQUIREMENTS

The final report will include an overall assessment of the issues listed in the section “IV. Purpose of Assessment” and will address the questions listed in the section “V. Assessment Questions”.

Other information to be included in the report will be determined in consultation with USAID staff over the course of the assessment.

The final report will be submitted to USAID/Russia on diskette in MS Word with ten hard copies as well. The report should be written by a native English speaker. The structure and format of the report will be proposed by an assessment team and approved by the Coordinator at the beginning of the assessment. The final report will primarily be for internal use by USAID project management. The contractor should submit a copy of the final report to the library of the Center for Development Information and Evaluation (CDIE), PPC/CDIE/DI. It may, at USAID’s determination, be disseminated to outsiders.

VIII. TEAM COMPOSITION AND PARTICIPATION

A team comprised of three US consultants and two Russian consultants will carry out the evaluation with one of these American consultants acting as team leader. Additionally, one support staff person will support the team as an interpreter and logistics coordinator. It is highly recommended that one of the US consultants is fluent in Russian. Fieldwork may be augmented by USAID Mission staff, as available. The members of the team are as follows:

- Team Leader: Responsible for coordinating and directing the reporting effort, including preparation and submission of the draft and final report. The incumbent should have extensive overseas program evaluation experience, including USAID experience, preferably in the E&E region. He/she must be thoroughly familiar with techniques of program appraisal. As team leader, the incumbent should possess excellent organizational and team-building skills.
- Four business development experts: Two of them should be familiar with USAID programs in the area of small business development. These consultants should have a combination of consulting experience that includes small business development, business promotion and management. These consultants should also be familiar with the role that both federal and local governments, non-governmental organization, communal service providers and financial institutions play in the development of a strong small business sector. Possession of both overseas and evaluation experience is a plus. At least one of these experts should have real life small business experience

capable of providing an analysis on the unique business opportunities of the RFE, not necessarily from a donor's perspective.

- Interpreter and Logistics Coordinator: He/she should have knowledge of terminology related to small business activities. He or she will translate conversation between the evaluation team and Russian-speaking program participants, as well as any Russian language documents provided to the evaluation team. Experience in simultaneous translation is desired. This person will be also responsible for all necessary actions as a Logistic Coordinator (i.e. schedule, meeting arrangement, tickets, etc.).

APPENDIX TWO

LIST OF INTERVIEWS¹

UNITED STATES

- Edward R. Leon, Management & Financial Consultant, Alaska Business Strategies
- Dan Berkshire, President, Global Perspectives, Inc.
- Alex Krasnev, Global Perspectives, Inc.
- Russ Howell, Executive Director, American Russian Center, UAA
- Dennis DeSantis, Sr. Vice President, Europe & Asia, ACDI/VOCA

BLAGOVESHCHENSK

- Sergey A. Gorbasenko, Deputy General Director, Joint Stock Company “FLIBUSTIERS”
- Vitalii G. Butenko, Executive Director, Joint Stock Company “T&M”
- Svetlana V. Lobach, Victualler, Bar–Restaurant “CONTINENT”
- Andrei Konushok, Project Manager, Center for Foreign Trade and Investment Support
- Ludmila Salnikova, Head of Economic and Prognostic Department, City Administration
- Tatiana Mosenzova, Head of Foreign Relations Department, City Administration
- Nadezhda V. Kikot, Deputy Director, Far East Mutual Credit Bank
- Vladimir I. Checulae, Chair, Economic Committee, Amur Region Admin., Econ. Committee
- Vladimir N. Ovechkin, Head of Small Entrepreneurship and Material Balances Support Department, Amur Region Administration, Economic Committee
- Galina Prichodko, Director, Intourist – Blagoveschensk
- Tatiana Danchenko, Vice-Director, Intourist – Blagoveschensk
- Sergey Kramorenko, Manager of Outbound Department, Intourist – Blagoveschensk
- Anatolii V. Telyk, General Director, Joint Stock Company “AMUR FAIR”
- Valentina P. Kobzar, Head of Press Center, AMUR FAIR – Consulting

CHITA

- Alexander Novoseltsev, Head of International Economic and Interregional Relations Dept., Regional Administration
- Vasily P. Borodin, Chairman of the economic committee, City Administration
- Tatyana N. Loseva, Deputy Director, Regional Fund for small business support
- Yuri M. Kon, Chairman, Profsoyuz Predprimateley (Trade Union-Entrepreneurs)
- Oleg F. Farzaliev, CEO, Profsoyuz Predprimateley (Trade Union-Entrepreneurs)

¹ This list provides the assessment team’s best efforts to compile a list of those individuals with whom it met. However, the assessment team had a number of meetings with groups of businesspeople or government officials at which it was not possible to obtain the names and affiliations of each participant.

- Mikhail Stepanov, President, Vasha Reklama Ltd.
- Alexander M. Dukker, Chairman of the Board, Chita Furniture and Wood Processing Plant
- Vyacheslav E. Ionov, Director, Makaveevsky meat processing plant
- Evgeniy Diachkov, Deputy Director, Makaveevsky meat processing plant
- Valentina Portnova, Head of the Branch, Chita Branch of Vneshtorgbank
- Sergei V. Rusaev, Director, “Slavyanski-Electronika” Trading House
- Sergei A. Seleznev, Director general, “Panama-City” Motel
- Anatoli D. Lokaichuk, President, “LiK” (cedar wood nut processing company)
- Tatyana A. Strizhova, Senior researcher/Representative, Chita Institute of Natural Resources; “Baikal” Fund

KHABAROVSK

- Stanislav P. Bystritsky, Vice-Director, Ministry for Economic Development and Trade of Russia, The Far-Eastern Research Institute of Market Economy
- Edward Petin, Director (Khabarovsk Branch), DeltaLease-FE
- T. Maeda, Director, Japan Center in Khabarovsk
- Larisa A. Yun, Assistant Director, Japan Center in Khabarovsk
- Igor Yu. Vostrikov, Vice-President, Far-Eastern Chamber of Commerce & Industry
- Alexander Nikulin, Chairman, IAITO
- Aleksei Shumilov, Director, Fund for Small Business Support “Counterpart Enterprise Fund”
- Elena Karpova, Journalist, VTSIOM (data collection & polling business)
- Mr. Shevelev, Owner, Furniture business
- Andrei S Zakharenkov, President, RFE Non-Timber Forest Products Association
- Zinaida M. Romashkina, First Vice-President “RegioBank”
- Sergey I. Lopatin, First Vice-Minister, Ministry of Economic Development of Khabarovski Krai
- Irina A. Besedina, Division Head of external relations and tourism department, Ministry of Economic Development of Khabarovski Krai
- Rinat M. Gainiakmetov, President, “Merilen” food processing company
- Alexander G. Ivanchikov, Investment Officer, DAIWA Far East and Eastern Siberian Investment Fund
- Alexander A. Shevchenko, Chief, Small Business Division
- Sergey V. Popov, “Sigma Forest”
- Maxim V. Petrushin, “Sigma Forest”
- Lydia V. Volkova, Component 3 Task Manager, Winrock International
- Nina I. Danilyuk, Senior Administrator, Winrock International
- Vitaly S. Wells, Executive Director, Khabarovsk region, Producers and Entrepreneurs Association, Executive Director
- Eugeny N. Shulepov, Khabarovsk region, Producers and Entrepreneurs Association, Chairman
- Vadim K. Zausaev, Professor, Doctor of Economics, Director, The Far-Eastern Research Institute of Market Economy, Ministry of Economic Development and Trade of Russia

- Dr. Stanislav Bystrytsky, Vice-Director, The Far-Eastern Research Institute of Market Economy, Ministry of Economic Development and Trade of Russia

MOSCOW

- Peasley, Carol, Mission Director, USAID
- Stein-Olson, Monica, Deputy Mission Director, USAID
- Lewman, Raymond L., Chief, Business Development Division (BDI), USAID
- Shevchenko Yulia V., Project Management Specialist (BDI), USAID
- Fisher-Gormley, Nancy, Program Officer, Office of Program and Project Development, USAID
- Kiseliy Andrew, Regional Initiative Coordinator, Program Office, USAID
- Korepanov Denis, Evaluation Officer, Program Office, USAID
- Pashina Ekaterina, Financial Analyst, Office of Financial Management, USAID
- Vikhrova Lydmila N, Ph.D., Senior Environmental Economist (BDI), USAID
- Miroslav V. Nikoruk, Director of the Morozov Project, Academy of Management and Market
- Michael O. Shishkin, Financial Director, Academy of Management and Market
- Oksana A. Yevtushevskaya, Head of Loan Dept., DeltaLease
- Viatcheslav V. Chiline, Business Development Manager, DeltaLease
- Alexander S. Puzanov, Ph.D., General Director, The Institute for Urban Economics
- Raevsky Aleksander P., Deputy Director, Center for International Private Enterprise (CIPE)
- Nathanson, Neal, Chief of Party, Citizens Democracy Corps (CDC)
- MacLeod, Stephen, Development Alternatives, Inc.
- Zinoviev Nikolai, Director General, DeltaLease
- Nielsen, Bryan, Programme Coordinator, European Bank for Reconstruction and Development
- Kuzmichev Evgniy P (PhD.), Deputy Project Manager, Forest Project (Winrock International, Chemonics)
- Milanova Elena V., Program Coordinator, Institute for Sustainable Communities
- Butovsky Ruslan O. (Dr.), ROLL-2000 Manager, Institute for Sustainable Communities
- Moralev Gleb V. (Dr.), Environmental Projects Coordinator, ISC
- Volkov Andrei E. (Dr.), Environmental Specialist, Institute for Sustainable Communities
- Nina A. Kunznetsova (Dr.), Executive Director, Junior Achievement – Russia
- Vladimir Drozhzhinov (Dr.), Project Director, E-Government Competence Center, AmCham
- Suzanne Decker, Chief Operating Officer, KMB Bank
- Oleg Zamulin (Dr.), Vice Director, Center for Economic and Financial Research

ULAN-UDE

- Tatiana Gavrilovna Dumnova, Minister of Economy and External Relations, Buryatia Republic

- Dmitri A. Ivailovsky, Head of External Relations Dept., Buryatia Republic
- Pavel G. Filatov, Acting Chairman of Small business Committee, Buryatia Republic
- Vyacheslav G. Irildeev, Chairman of Economic and Environmental Committee, People's Hural of Buryatia Republic
- Aldar Badmaev, Director General, "Makon" Business Support Center
- Yanzhima D. Vasilieva, President, Siberian NTFP Association
- Oleg B. Khomutov, Chairman, Association for the Protection of Taxpayers' Rights
- Vladimir D. Tsydenov, Director, BIN-Asia Bank (Affiliate of BIN Bank).
- Vladimir F. Belogolovov, Director, East-Siberian Regional Center of ISC
- Lev A. Asalkhanov, Director, "ZOL" Construction Company
- Stanislav Y. Sergeev, Director, "Technodom" Wood processing company

VLADIVOSTOK

- Pamela Spratlen, Consul General, American Consulate
- Irina N. Isaeva, Project Management Specialist (Russian Far East), American Consulate General, USAID
- William S. Lawton, Principal Commercial Officer, American Consulate
- Greg Sundstrom, VP & Regional Director, DeltaLease – Far East (TUSRIF)
- Konstantine Mironenko Partner & CEO, Teplon Company (alternative energy products) & Belost company, (Heating/Cooling products)
- Igor Lulenkov, Partner & CEO, DIKA-ties Co. (wood processing and treatment)
- Alexander Balykov, Partner and Manager, Ussirisk Concrete Components Plant (building products)
- Igor Belov, Architect, Partner and manager, NASLEDIYE-ROSS, Standart Construction & Design (commercial and residential re-modeling and construction)
- Elvira Belova, Partner and manager, Milenium Furniture Showroom
- Andrey Razgonov, Manager, Furniture Factory
- Boris L. Steinhardt, Executive Vice President, Far Eastern Bank
- Natalia M. Mansurova, Vice President, Far Eastern Bank
- Evgeniy V. Kutsurin, Head of Documentary Business and Correspondent Banking Dept, Far Eastern Bank
- Yulia S. Bekreneva, Manager of Documentary Business and Correspondent Banking Dept., Far Eastern Bank
- Sergei V. Babichev, Deputy Chairman of the Board, Primotsbank
- Andrey N. Oleinik, Head, International banking division, Primotsbank
- Elena V. Korneeva, Head of Correspondent Banking & Documentary Business Dept., Primotsbank
- Olga S. Ivaschuk, Specialist, Correspondent Banking & Documentary Business Dept., Primotsbank
- Anatoly I. Vasilchenko, Chief of Analytic Department, Primotsbank
- Vladimir V. Shaporenko, Head of Loan Dept., Primotsbank
- Ludmila A. Mitrofanova, Head of Business Development Dept., Primotsbank
- Galina F. Yashenkova, Director, Credit Union Rodina
- Irina N. Chaika, President, Association of Credit Unions of Primorsky Region
- Anna B. Popova, Director, Corps of Executives - Far East Russia, Consulting

- Alexander V. Popov, President, Corps of Executives - Far East Russia, Consulting
- Svetlana A. Volyntseva, Owner/Manager, Bonus Furniture Store
- Igor Volyntsev, Entrepreneur, Starting small business in timber processing
- Klavdiya V. Spivak, Director, Far Eastern Board of Business Advisers (FEBBA)
- Olivia Kantisheva, Deputy Director, Far Eastern Board of Business Advisers (FEBBA)
- Vladimir N. Lychagin, Co-founder, Restaurant “Old City”
- Mikhail V. Popov, Director, Vladivostok Porcelain Factory
- Konstantin N. Porublev, Senior credit Specialist, EBRD/Russia Small Business Development Fund
- Evgenia V. Terekhova, Director, Center for Citizen Initiative / Performance Enhancement Program (CCI-PEP), former President & Director of Int’l Activities, Rotary Club #2
- Joan A. Agerholm, Regional Director, Eurasia Foundation, RFE Office
- Toshiharu Asai, Director, Japan Center in Vladivostok
- Yuri Darman, Ph.D., Director, World Wildlife Fund Russia, FE Branch, Forest Enterprise & Ecotourism Program
- Vyacheslav Odintsov, Ph.D., Managing Director, World Wildlife Fund Russia, Far Eastern Branch, Forest Enterprise & Ecotourism Development
- Vladimir P. Karakin, Sustainable Development Programs Coordinator, World Wildlife Fund Russia, Far Eastern Branch, Forest Enterprise & Ecotourism Development
- Anton E. Lozinsky, Ecotourism Coordinator, World Wildlife Fund Russia, Far Eastern Branch, Forest Enterprise & Ecotourism Development
- Natalia Vitskovskaya, Head, Junior Achievement Center for Primorsky Krai
- Nikolai Kazakov, Project Manager, Wildlife Conservation Society
- Leonid N. Alexeiko, First Vice-rector, Director of Morozov regional center, Far Eastern State Technical University (FESTU)
- Elena B. Starikova, Teacher, manager of Morozov regional center, Far Eastern State Technical University (FESTU)
- Yuri Boiko, Teacher, manager of Morozov regional center, Far Eastern State Technical University (FESTU)
- Viacheslav A. Andreev, Chairman, Primorsky Krai Administration, Economic Development Committee
- Vera M. Evtushenko, Head, Primorsky Krai Administration, Small Business Support
- Alexander P. Zharov, Chairman, Vladivostok City Administration. Economy and Management Committee
- Sergei I. Verolinen, Head, Vladivostok City Administration. Economic Policy and Business Development Dept.

YAKUTSK

- Yuri A. Ignatiev, First Deputy Minister, Sahka Republic (Yakutiya) Ministry of Foreign Relations.
- Anatoly N. Skrybykin, Minister, Ministry of Business, Tourism and Employment Development of Sahka Republic (Yakutiya)

- Marina Yu. Guivanskaya, Deputy General Director (Purchasing & Sales), production unit, “Seamstress of the North”
- Nelly M. Kim, Production Director, Production Unit, “Seamstress of the North”
- Michael S. Fillipov, General Director, Small Entrepreneurship Support Fund of the Sakha Republic (Yakutia)
- Dmitrii V. Fillipov, General Director, State Organization “Republican Information & Marketing Center”
- Sargylana M. Baisheva, Deputy General Director, State Organization “Republican Information & Marketing Center”
- Sargylana M. Bagisheva, Editor-in-Chief, “The Entrepreneur of Yakutiya”
- Nelly M. Kim, Deputy General Director on Production, “Shveya Severa”
- Marina Y. Guyvanskaya, Deputy General Director on logistics and marketing, “Shveya Severa”

YUZHNO-SAKHALINSK

- Natalya G. Ivanova, Community and Fisheries Liaison, Exxon Neftegas Limited
- Konstantin Klebleyev, Managing Director, InterraMashService, LLC
- Peter Sadovnik, Director, InterraMashService, LLC
- Alexander Dashevsky, Technical Director. Sakhalin Travel Group & Associate, Sakhalin-Alaska Group, LLC (consulting)
- Tatyana A. Garsherina, Chairperson of the Board, Sakhalin Association of Businesspeople
- Nikolay V. Litvin, Head of Board, Ministry of Russian Federation for Anti-monopoly Policy and Enterprise Support, Sakhalin Territorial Board
- Sergei Karpenko, Deputy Head, Sakhalin Regional Administration Economic Committee. Investment Attracting Dept.
- Alexander A. Zolotarev, Head, Sakhalin Regional Administration Economic Committee, Sector Development Dept.
- Irina Ryabtseva, Head, Sakhalin Regional Admin. Economic Committee. Investment Dept.
- Elena Nedzelnitskaya, Government Relations & Client Services Specialist, American Business Center
- Elena Vjunova, Director, Small & Medium Enterprise Support Center
- Ken Smith, Project Director, Senior Banking – Credit Advisor, ACDI/VOCA Regional Micro-credit program
- Oksana V. Molodtsova, Director, Russian-American Business Training Center
- Elena A. Shugaeva, Project Manager, Russian-American Business Training Center
- Sonia Ghayem, Program Manager, FRAEC
- Elena A. Sabirova, Business Specialist, BISNIS

APPENDIX THREE

INTERVIEW PROTOCOL

A. Interview Questions for Donors and Contractors

Background and Experience

1. What is the nature of your activities with respect to SME development in the RFE (training/general business services/consulting/financing/credit providers/other) – please specify)?
2. What do you view as the key achievements in RFE SME development of your organization over the past two years – i.e., where have you/your contractors had the greatest impact (i.e., best practices, highest impact activities, other)?
3. Do you have any data on the effectiveness of your program/s that you can share with us – for example, number of firms/individuals who have used your services, volume or number of loans extended, or any other relevant indicators?
4. In what arenas have you had the most difficulty in bringing about positive change in SME development?
5. What are the key lessons you have learned about how to bring about positive change in the arena of SME development?
6. In your experience, how does the environment for SMEs in [present city/area/region] differ from that of other parts of the RFE/Russia – the same, better, or worse? How and in what ways?

Future Focus

7. What sectors do you think are the most promising for your activities with respect to SMEs (*specifically with respect to oil and gas, ecotourism, non-timber forest products, timber, fisheries*)?
8. What do you think are the arenas in which donor organizations will be able to have the most impact on SME development and growth?
9. What do you think are the next key steps for development of SMEs in the RFE?

B. Interview Questions for Government Officials

Background

Only if relevant and appropriate:

1. What is the approximate size of the SME sector (*important – confirm the definition of SME being used*) in your city/region, in terms of

- % of GDP
- % of employment
- Importance of SMEs to economic growth (high/medium/low)
- Sectors in which SMEs are
largest/most important
smallest/less important

2. Given the universe of administrative and governmental priorities – including education, health care, infrastructure development, environmental issues, etc. – how do you view the relative importance of SME development (high/medium/low)?

Environment for SME Development

3. How would you characterize the business environment for SMEs – specifically –

- Details of local regulatory requirements (tax, inspections, licenses, certifications, other administrative issues, etc.)
- Role of business associations
- Overall, how does the business environment for SMEs differ from that for other companies – the same, (b) better, or (c) worse? How?

4. How do you/your office participate in the development and growth of SMEs? In which sectors in particular are your efforts focused (*specifically with respect to oil and gas, ecotourism, non-timber forest products, timber, fisheries*)?

5. What are the relevant government bodies in your region/city area that support SMEs and their development?

6. What are recent/ongoing government-related initiatives with respect to SMEs?

7. What in your view are the three biggest problems that these initiatives face in facilitating the growth of SMEs? How are these problems different from those faced by companies that are not SMEs?

8. What are the key lessons that you/your office has learned with respect to supporting the development of SMEs?

9. How do you view the SME development services available in your region (i.e., training/general business services/consulting/financing/credit providers/other)? Are you aware of donor efforts to help SMEs?

Contingent on answer to the above question,

10. In what arenas have donor projects and developmental assistance been most helpful/had the greatest impact (i.e., training/general business services/consulting/financing/credit providers/other – please specify)? (if

relevant/appropriate, indicate which donor organizations and/or contractors were involved with these activities)

11. What would be the most effective way for you to receive help or assistance to address the problems that stand in the way of SME development that you mentioned above (for example, through receiving support for training, general business services, consulting, financing, providing credit, other)?

12. In what sectors in your region do you think SMEs are the most promising, from a business perspective (*specifically with respect to oil and gas, ecotourism, non-timber forest products, timber, fisheries*)?

13. What do you think are the sectors in which you/your office could have the most impact in helping SMEs (*specifically with respect to oil and gas, ecotourism, non-timber forest products, timber, fisheries*)?

14. What do you think are the next key steps for the development of SMEs?

C. Interview Questions for Business Managers and Businesspeople

Background

1. What is the nature of your business?

2. When was it started?

3. Other details:

- Sector
- Number of employees
- Competitive environment
 - level of competitiveness – high/medium/low
 - competition based on price and/or quality and/or other (specify)
 - who are key competitors – SOEs or private companies
- Revenues
 - up to RUB 3 million;
 - between RUB 3 million and RUB 10 million;
 - between RUB 10 million and RUB 20 million;
 - between RUB 20 million and RUB 30 million; or
 - more than RUB 30 million

4. Do you expect your company to be profitable in 2002?

5. Are you satisfied your present level of profitability? Why or why not?

6. How does your company's performance in 2002 thus far compare with that of the same period of 2001?

7. To what do you attribute the change (or lack thereof) in your company's performance (for example, economic environment; competitive environment; regulatory pressures; taxation levels; other)?

8. Are you a member of a business association (if Y, specify)? Why or why not?

Environment for SMEs

9. How would you characterize the business climate for SMEs – specifically –

- details of local regulatory requirements (tax, inspections, licenses, certifications, other administrative issues, etc.)
- access to finance (loans, equity, leasing, debt, etc.)
- barriers to entry
- role of business associations
- overall, how does the business environment for SMEs differ from that for other companies – the same, (b) better, or (c) worse? How?

10. What are three largest problems that your company faces?

Assistance

11. Have you ever used services provided by a business services provider (i.e., training/general business services/consulting/financing/credit providers/other)?

12. If Y, who was the service provider? *(if relevant/appropriate, indicate which donor organizations and/or contractors were involved with these)*

13. Was the assistance helpful?

14. What kind of results did you achieve (best practices)?

15. What kind of additional services would be helpful (i.e., training/general business services/consulting/financing/credit providers/other)?

16. What do you think are other sectors that are attractive, from a business perspective, for SMEs? (If you were to start a new SME, what sector would it be in?) *(specifically with respect to oil and gas, ecotourism, non-timber forest products, timber, fisheries)?*

For large companies only

17. What goods and services does your company purchase from other companies in this region (for example, production inputs; transportation services; accounting and payroll services; legal services; training; maintenance; deliveries; etc.)?

18. Has your firm considered purchasing (i.e., outsourcing) other goods or services from local firms, rather than producing them within the firm? What factors stand in the way of your firm doing more outsourcing?

19. What do you think might be done to strengthen local SMEs so that they could be more reliable business partners?

20. To what extent do you think large and small companies face similar (or different) conditions for doing business (for example, with respect to tax issues; licensing and inspections; weakness of the banking system; labor regulation; training; energy costs; transportation; difficulty in enforcing contracts; other infrastructure deficiencies; etc.)?

**D. Interview Questions for Business Service Providers for SMEs
(i.e., credit providers/consulting firms/training centers/incubators)**

Background

1. What is the nature of your activities with respect to SME development in the RFE (training/general business services/consulting/financing/credit providers/other) – please specify)?

For for-profit entities only

2. Do you expect your company to be profitable in 2002?

3. Are you satisfied your present level of profitability? Why or why not?

4. How does your company's performance in 2002 thus far compare with that of the same period of 2001?

5. To what do you attribute this change (for example, economic environment; competitive environment; regulatory pressures; taxation levels; other)?

6. What are three largest problems that your enterprise faces?

7. Who are your key customers, in terms of

- Sector
- Size (number of employees of customers)
- Longevity of relationship with customer

Environment for SMEs

8. How would you characterize the business climate for SMEs – specifically –

- Details of local regulatory requirements (tax, inspections, licenses, certifications, other administrative issues, etc.)
- Access to finance (loans, equity, leasing, debt, etc.) – where do SMEs get money for investment?
- Barriers to entry
- Role of business associations
- Overall, how does the business environment for SMEs differ from that for other companies – (a) the same, (b) better, or (c) worse? How?

9. *(if not covered by above question)* In what areas has your organization had the greatest impact (i.e., best practices, highest impact activities, other)?

10. What are the key lessons that you have learned in the process of servicing your SME customers?

11. What are the three issues that you most frequently help your SME customers with?

12. What do you think your SME customers need the most to grow and develop?

13. In your experience, how does the environment for SMEs in [present city/area/region] differ from that of other parts of the RFE/Russia – the same, better, or worse? How and in what ways?

14. What sectors do you think are the most promising for your activities with respect to SMEs *(specifically with respect to oil and gas, ecotourism, non-timber forest products, timber, fisheries)*?

APPENDIX FOUR

Assessment Team Members

Mikhail Annenkov has spent much of his career focused on business development issues, and has extensive hands-on experience with assisting SMEs in Russia. He has been the director of business development for a medium-sized Russian manufacturing company, where developed and managed the implementation of a quality management system to bring the company's certifications up to international standards. On another front, Mr. Annenkov served as director of a business development program carried out in conjunction with the Swedish Institute of Management. Mr. Annenkov has also been a consultant to local administrations to help them formulate economic development and investment promotion strategies. Mr. Annenkov holds an MBA from the Open University Business School in the United Kingdom.

Ken Hill has more than 20 years of experience in international development. Mr. Hill has served as a Peace Corps Country Director for programs in eastern Russia, Bulgaria and Macedonia. He subsequently held the positions of Chief Operating Officer, Chief of Operations for the Europe, Mediterranean and Asia Region, and other senior posts in the Peace Corps. In the early days of the Peace Corps, Mr. Hill served as a rural development Peace Corps volunteer in Turkey for two years. Mr. Hill also spent 14 years as an entrepreneur, during which time he developed and operated a marina in Solomons Island, Maryland, and an independent consulting firm in Alexandria, Virginia. Mr. Hill is presently a freelance consultant.

Kim Iskyan, a freelance consultant and analyst, has spent the past seven years working in the financial markets of the former Soviet Union. Most recently he was deputy head of research and a director at Renaissance Capital, a boutique investment bank in Moscow focused on the Russian market, where he advised domestic and international investors on the Russian investment environment. Prior to moving to Moscow in 1996, Mr. Iskyan was a consultant for Price Waterhouse (now IBM) in Washington, D.C., where he helped managed donor capital markets development projects in the emerging markets. He subsequently worked in Bishkek, in the Kyrgyz Republic, as part of a USAID contract to develop the country's capital markets infrastructure. Previously Mr. Iskyan worked for Oppenheimer & Co., an investment bank in New York, on the Latin American securities sales and trading desk, and later in the investment banking group. Mr. Iskyan is a graduate of Brown University, and earned a master's degree in history at the University of Pittsburgh.

Konstantin Kornev, is a Moscow-based consultant and project coordinator for Global Management and Consulting Services, Inc., an international consulting company. For the past five years Mr. Kornev has managed a number of World Bank technical assistance projects focused on a range of issues, including standards development, energy efficiency, and social services reform. Previously he spent five years as a business owner,

including two years as the senior manager/CEO of a family-owned and –run business. Earlier in his career Mr. Kornev worked for the Soviet (and later Russian) Foreign Ministry, both in Hanoi, Vietnam as a foreign policy expert and protocol chief, and later in Moscow. Mr. Kornev holds a degree in international economic relations from the Moscow State Institute of International Relations.

Andrey Vasiliev is the Donor Projects Director of CARANA Corporation’s Moscow office. As an official in the Moscow municipal government in 1991-1992, Mr. Vasiliev participated in the early stages of enterprise privatization in Russia. He worked with the Economic Development Institute of the World Bank, where he focused on the analysis of the privatization experience of small and medium enterprises in Eastern Europe, and the dissemination of his group’s findings to senior governmental officials throughout CIS. Subsequently Mr. Vasiliev was an associate in the Moscow office of the Economic Intelligence Unit, where he performed various macro- and microeconomic studies for multinational clients. Since joining CARANA in 1998, Mr. Vasiliev has served as a project manager for a number of donor and non-donor projects, including an assessment of the economic potential of the closed nuclear city of Zheleznogorsk; a marketing study for the closed nuclear city of Snezhinsk; the development of a strategy for the Business Opportunities Bureau of the Federal Center of Project Finance; and the restructuring of the postal system of the Russian Federation. Mr. Vasiliev holds a degree in International Economic Relations from Moscow State University.

Gerald Wein, the team leader of this assessment, is a development economist and program manager. He holds masters degrees in economics from the University of California (Berkeley) and in public administration from Harvard University. Mr. Wein worked for USAID as an economist, project planning and evaluation specialist, and senior program manger. His experience includes 15 years as a resident development specialist in six Latin America and Africa countries, and short-term assignments in more than 40 countries in all developing regions of the world. He has served in a variety of management positions, including as Deputy or Acting Mission Director of USAID programs in Nicaragua, Tunisia and Ecuador and, after leaving USAID, as the director of projects that provided technical assistance on health sector finance and policy reform to more than 35 countries. Mr. Wein is currently an independent consultant. His recent work includes seven project evaluations or assessments carried out for USAID/Moscow by the CARANA Corporation.

APPENDIX FIVE

Problems with Russian Data on SMEs

Regional variations: Russian regional data are collected from a wide range of sources that are rarely comparable and sometimes not internally consistent. The assessment team elected not to use that data. The assessment team instead relied on the SME Observatory Report, which employed consistent analytical techniques across regions. One limitation of the Observatory Report, however, is that some of the data provided are not broken down beyond the Federal Okrug level.

Ownership: Many enterprises in Russia (of every size) still have mixed ownership, i.e., part private and part public sector. Most developed country definitions of SMEs allow only for privately-controlled companies to be included in tallies of the SME sector. The Russian definition of SMEs allows for up to 25% state ownership.

Quantifying the unquantifiable: A significant but unknown number of SMEs are not officially registered with the relevant authorities – which makes tracking them difficult. Additionally, registered companies that are no longer operational are frequently not taken off the official lists, further distorting data on the number of operational SMEs. Use of these data implicitly implies that the number of registered firms that exist but are not registered and those that are registered but do not exist cancel each other out. Additionally, SMEs registered with relevant authorities frequently provide false or misleading information so as to minimize their regulatory and fiscal burdens.

When an SME is not an SME: Some large companies are re-organizing their legal structure to take advantage of fiscal (taxation) and other incentives provided to SMEs. For example, the manager of a successful diversified company – one employing 250 people involved in a publishing, food processing, retail trade and real estate development -- indicated his intention to split his company into seven separate legal structures so as to benefit from fiscal incentives offered to smaller firms. Variations in tax incentives to business (along with the variations in definitions discussed in this report) make comparisons of SME development across countries risky.

APPENDIX SIX

Other Industries with Potential for SMEs in the RFE

Construction shows significant potential. There are, however, several caveats:

- Construction normally involves medium and large companies rather than SMEs. Large construction companies are a legacy of the Soviet past when they were used to build gigantic industrial installations and apartment complexes. Some of these firms dissolved within the past decade; others have survived at a reduced level, often with long-standing wage arrears.
- Construction is heavily dependent on medium to long-term financing which is difficult to obtain. Construction firms report that it is usually impossible to get working capital funding for periods longer than one year unless federal, regional or municipal guarantees are involved. Larger construction projects have included the renovation of industrial complexes and road construction or repair. The quantity of new construction is limited, although the assessment team observed a reasonable amount of such activity in some cities (e.g., in Yuzhno-Sakhalinsk, Khabarovsk, Vladivostok and Yakutsk).
- Construction SMEs are finding an important niche in residential construction and apartment re-modeling. With an enormous backlog of maintenance in the housing sector, rising middle class incomes and limited opportunities for investment (i.e., weak equity markets and widespread mistrust of the banking system), demand in this area is likely to grow.

Overall, the revival of the construction industry in the RFE is encouraging, although it cannot be compared to the massive boom that the industry is experiencing in Moscow and several industrial cities of central Russia.

Furniture production is expanding. Discussions with producers in Khabarovsk and other cities indicate that production is aimed both at the local market and at “export” to other regions of the country, including to Central Russia. Export production is usually unsophisticated (e.g., standard kitchen sets); more elaborate orders are produced on-site. RFE furniture makers enjoy relatively easy access to raw materials at favorable prices, but their comparative advantage is reduced by high transportation costs.

Retail trade is dominated by SMEs and individual entrepreneurs. Newly-enacted legislation should simplify registration, tax-collection and inspection problems, although many businessmen continue to complain about the administrative barriers. The latter include excessive inspections by various administrative bodies, including sanitary, fire and licensing inspections. Excessive inspections remain a serious problem for SME development, diverting production time and creating opportunities for bribery.

Tourism in the Far East is largely oriented towards China, Japan and South Korea. SMEs are very active in this industry. “Shuttle-trading” tours predominate. Inland tourism (within Russia) is also popular, particularly when it involves inexpensive tours to other parts of Russia. However, the volume of the latter is threatened by steadily rising transportation tariffs. Many SME tour operators offer vacation packages to Mediterranean and Southeast Asian countries, but demand is limited by the high cost relative to incomes.

Clothing production in the RFE must compete with inexpensive imports from China and South-East Asia. As a result, SMEs in the RFE tend to focus on the region’s traditional garments designed for the severe cold and on uniforms (e.g., working clothes, surgical coats etc.) specific to local institutions. Although most clothing manufacturing and virtually all clothing sales are now in private hands, some of the larger firms continue to have at least partial public sector ownership. One such firm that the assessment team visited exhibited considerable signs of inefficiency, including a large number of idle machines, poor use of available space and workers who seemed to lack motivation.

APPENDIX SEVEN

Findings: The Environment for SMEs in Selected Cities

This appendix provides the team's findings on the seven cities/regions that it visited: Blagoveshchensk, Chita, Khabarovsk, Ulan-Ude, Vladivostok, Yakutsk, and Yuzhno-Sakhalinsk.

A. Blagoveshchensk

Background

Blagoveshchensk is the administrative center of the Amur region, situated between Khabarovski Krai to the East and Chita Oblast to the West. The Amur River divides the southern border of this state from China to the south and it shares a northern border with the Republic of Sakha. The Amur region has a total population of slightly less than one million people. Blagoveshchensk has just over 220,000. Other key cities in the region include Belogorsk (population of 74,000), Svobodniy (70,000) and Tynda (46,000).

The economy of the Amur region is closely linked to the Trans-Siberian railway, which is the key transportation artery through the area. Military installations, a rich mineral resource base, and timber are also important to the region's economy, which has been growing faster than the Russian economy as a whole over the past few years.

USAID involvement in this region has been limited. With respect to SME development, the EBS program included Prognoz, a Blagoveshchensk-based BSI. That organization claims to have benefited considerably from its participation in the EBS project, expanding the client base for its emerging consulting business.

Obstacles to SME growth

- **Lack of credit availability:** SMEs in the Amur Region do not have access to adequate sources of funding. Few banks service the region, and even fewer are willing to lend to small- and medium-sized enterprises. There are no micro-finance institutions operating in the area. One key exception was Dalnevostochnoye O.V.K. (the local successor institution to SBS-Agro), which reported that it lends to 4,500 SME customers, and makes loans as small as RUB 7,500 (\$238). The option of leasing equipment is available, but is practical for only a very small segment of SMEs. The city's SME support fund is small, and is unlikely to have any measurable impact on the funding opportunities for SMEs. The city administration also finances a business incubator that is assisting six to ten small firms. This is a useful activity, but its small scale will limit its impact.
- **Geographic remoteness:** Goods are transported to Blagoveshchensk via the Amur River, the Trans-Siberian railway, or by air. The Amur River, however, is frozen over much of the year, making its use highly seasonal. Air service is expensive and infrequent. Train service is reliable and frequent, but fairly expensive and slow.

- **Administrative barriers:** Businesses factor the costs of administrative barriers into their business costs, which raise barriers to entry and makes goods and services more expensive.

Opportunities

SME development in Blagoveshchensk is significantly more developed than that of Chita. The city does not boast of the dynamism of Vladivostok or of the opportunities available to savvy SMEs in Khabarovsk.

The assessment team believes that one key opportunity for SME focus may be on the NTFP sector, most likely via expansion of the FOREST project to the area. The Blagoveshchensk area is particularly rich in non-timber forest products, and the sector appears to be underdeveloped.

The area's proximity to China appears to be both tantalizing and frightening for local businesspeople and administration officials. Developing further trade and tourism links with China is viewed widely as a significant opportunity for SMEs, but there is fear that Chinese investment (and perhaps people) may overrun the area and displace Russians.

B. Chita

Background

Chita Oblast is located more than 3000 miles from Moscow and 850 miles from Khabarovsk. Buryatia to the West, China and the Amur Region to the East surround Chita Oblast. It shares a long border with Mongolia to the South. The city of Chita has a population of 313,000, while the oblast as a whole is home to 1.3 million people.

Chita Oblast's major industries are timber, mining (coal, uranium), and sheep husbandry. Power production and transportation are also important to the local economy. Other areas of SME focus include secondary wood processing, tourism, services, food processing, and consumer goods. Most SMEs in Chita Oblast are focused on retail and trade, and SME involvement in production and processing is only in its initial stages.

Donor assistance is limited to a few ecological programs for the Baikal region. The local government's small business support fund, which had a budget of RUB10 million in 2002, receives support from the Eurasia Foundation.

Obstacles to SME growth

In terms of both general economic and SME development, Chita Oblast lags behind most other Russian regions, including those in the RFE. Its infrastructure is poor even by the standards of the RFE, with the railroad the area's main link with other parts of Russia and China. A new road that will link Khabarovsk and Chita is under construction, but will only be completed in 2007-2008. The local airport has been upgraded to support large aircraft, but air traffic is minimal. Power is expensive compared with other regions in the area, which means that production activities have a particularly difficult time achieving financial viability.

There are few banks active in Chita Oblast, and none of them are oriented to the needs of SMEs. According to local SME businesspeople, the lack of access to credit and the excessive bureaucracy necessary to obtain loans are among the major obstacles to SME development. The head of a large furniture production plant in Chita complained that he recently had to halt assembly for more than a month because of the slowness of its bank.

Generally speaking, the poor state of Chita Oblast's economy means that SMEs have faced an even more challenging set of difficulties than SMEs in many other areas of the RFE. The small size of the market in the Chita Oblast, due in part to logistical and transportation hurdles, has been a key barrier to SME development.

Opportunities

The assessment team met with a surprisingly large number of savvy businesspeople who have built solid companies despite the difficult business environment. A group of entrepreneurs recently formed a support group that appears to be well managed, and intent on working with the government to improve the environment for SMEs. In turn, the local administration seemed relatively SME-friendly, and focused on supporting the growth of SMEs; it recently approved a regional program for small business support, and reports that it frequently discusses the challenges faced by SMEs in a special council consisting of government representatives and local businesspeople.

A number of administration officials and businesspeople with whom the team spoke were enthusiastic about the possibilities of development through capitalizing on the Oblast's border with China, particularly in trade and ecotourism. The town of Zabaikalsk, for example, is one of three Russia-China border gateways, and receives 1.5 million Chinese visitors annually, most of them en route to other destinations. However, there is also a strong undercurrent of fear about the Chinese factor, and concern that unless Chita can source capital from elsewhere in Russia for growth, it will be overrun by investment from the Chinese.

The assessment team believes that there is considerable scope for donor efforts to make a relatively significant impact on the economy of Chita Oblast. In particular, NBFI programs, access to training, and extending volunteer programs to the Chita Oblast are the most promising arenas for USAID involvement.

C. Khabarovsk

Background

Most of Khabarovsk Krai is comprised of vast expanses of unpopulated territory. It stretches along the coast of the Sea of Okhotsk and the Sea of Japan for nearly 1300 miles. The population of the Krai is just over one million people. The city of Khabarovsk, an important regional industrial center, has a population of roughly 600,000. The city sits on the banks of the Amur River, some 200 miles from the Pacific Ocean and ten miles north of the Chinese border. Key industries in the Krai include timber, engineering and machine-building industries, oil refining, furniture making, and other

light industry. Agriculture is limited to cultivation of wheat, soybeans, oats, and vegetables in the Amur River basin.

The majority of SME activity in Khabarovski Krai takes place in the largest urban centers. Nearly two-thirds of the Krai's SMEs operate in the city of Khabarovsk, and most of the remainder in Komsomolsk-na-Amur, the second largest city in the Krai.

Khabarovski Krai has been the focus of considerable donor attention, including from USAID. Currently, SME-related USAID programs operating in the Krai include Working Capital Russia with Counterpart International, ARC, Delta Leasing, FOREST, ROLL, and Morozov. Previously, USAID supported the EBS program. (A description of these programs is provided in Section III.A above.)

Obstacles to SME growth

The problems that SMEs in Khabarovski Krai face are similar but not as severe as those for SMEs elsewhere in the RFE.

- **Lack of credit availability.** While a problem, the range of banking options available are considerably greater than is the case in most other parts of the RFE. One banking institution in the area, Regiobank, reported that its main focus is on servicing SMEs. DeltaLease-FE and other leasing companies offer credit for larger firms with an adequate track record. The local administration's SME support fund – which in addition to providing funding is also targeted at reducing administrative burdens on SMEs and creating new jobs – received U.S.\$0.5 million and RUB11.6 million in 2002. As is often the case with government-run credit programs, there is suspicion that decision-making on loans is influenced by political considerations.
- **Administrative barriers.** SMEs often complained of excessive inspections by a range of administration officials. More encouragingly, the local administration has developed a comprehensive SME support plan, encompassing legislative and policy measures as well as efforts to lower administrative barriers. According to some observers, there has been an improvement in the attitude of public officials toward SMEs over the past few years.
- **Public attitudes toward SMEs.** A recent and as-yet unpublished study conducted by the Far Eastern Institute for Market Research suggests a considerable improvement has occurred in the public's perception of SMEs'. That study, based on a telephone survey in the conservative city of Komsomolsk-on-Amur, revealed a very surprising 95% "positive" view of SMEs. This is marked change from a similar survey conducted three years ago.

Other problems that impact most of the RFE, such as distance to markets and high transportation costs, are not as profound in Khabarovski Krai due to its relatively favorable geographical location and better transportation infrastructure.

Opportunities

The Assessment Team believes that the level of SME development in Khabarovsk and in Khabarovski Krai does not warrant additional intervention by the Mission. However, the key programs in credit should be continued.

D. Ulan-Ude

Background

The mountainous Republic of Buryatia includes seventy percent of the coastline of Lake Baikal. While not as isolated as Chita Oblast, much of Buryatia is desolate and unpopulated. Ulan-Ude, the capital of the Republic, has a population of roughly 390,000, and the region as a whole has one million inhabitants. Buryatia is the home of Buddhism in Russia. The indigenous people of the area, the Buryats, constitute a quarter of the population of the Republic.

Buryatia's key industries are mining (iron ores, potassium, uranium, and, to a lesser degree, gold and silver, semi-precious stones, granite, marble, and brown and black coal). The other major industries are timber, machine building, and sheep husbandry. Buryatia exports a range of lumber and timber products, minerals, wool textiles, and helicopters - thanks to a large aviation plant founded in 1939 that still operates.

According to data provided by the local administration, Buryatia has slightly more than 31,000 SMEs. As is common throughout Russia, 91% of the SMEs are individual entrepreneurs while only 9% are registered businesses. SMEs account for 17% of total employment. Trade and services account for 48% of all SMEs; industrial activities accounts for 18% and construction, 14%. The remainder of the SMEs are involved in agriculture, transportation, public health and other services.

Obstacles to SME growth

Buryatia faces a range of obstacles to SME growth:

- **Government attitude:** The government does not have an SME support policy, and the small business support fund collapsed last year. Many local businesses rely heavily on political connections to achieve results.
- **Lack of credit:** The local affiliate of BIN Bank offers a small-scale loan guarantee program with USAID, but otherwise credit for SMEs is not readily available. Rumors that KMB Bank may be considering establishing a presence in Ulan-Ude are the subject of much speculation and interest in the SME community.
- **Poor geographic situation and infrastructure:** Buryatia suffers from underdeveloped infrastructure and insufficient transportation links. Power is expensive, as are other inputs, and the local market is small.

Opportunities

Buryatia and Ulan-Ude have benefited from a number of donor-assisted environmental programs (e.g., ISC, WWF) focused on Siberia and the Trans-Baikal region and business development programs (e.g., CDC, Morozov). The local administration is also showing

some signs of adopting a more positive attitude towards SMEs, and a younger generation is slowly moving into key areas of responsibility, both in the private and public sectors. The Eurasia Foundation is working with the Ministry of Economy on several initiatives. A strong local consulting company reports a solid market in developing business plans (both for regional governments of the Republic of Buryatia and private customers) and offers business training seminars.

The assessment team believes that the development of ecotourism and the expansion of credit availability are the key areas in which USAID could have a significant impact on SME growth in Buryatia.

E. Vladivostok

Background

Vladivostok is the 140 year old capital of Primorski Krai. Combined with the adjoining suburbs the official population is 1,000,000, 14% of the RFE total. It boasts an international airport and the primary Russian seaport in the Pacific Rim as well as the terminus for the Trans-Siberian Railway. Much economic activity is derived from borders shared with China and North Korea and close proximity to Japan and South Korea.

Other cities with significant economic activity in the Vladivostok area are Nahodka (another major seaport) and Ussurisk (industrial center and rail terminal). The economies of the three cities are closely linked.

Vladivostok is the primary educational center in the RFE with six universities including Far Eastern State University, Far Eastern State Technological University, Marine State University, Pacific Higher Naval Institute, Far Eastern Fishery University and Vladivostok University of Economics and Service. Several Institutes of the Russian Academy of Science are located at Vladivostok including Automation (computing), Marine Biology, Oceanography, Sea Technologies, Pacific and Biochemistry Institute. There are also private schools and trade schools in the city and its surrounds.

Vladivostok enjoys a diversified economy. The primary industries of Vladivostok include fisheries, ocean shipping, rail transport, construction, timber, trade, tourism and travel, service and light industry. The military establishment is still significant but has shrunk considerably since the Soviet era. Except for fisheries, all these sectors are either stable or growing, and SMEs play an expanding role in all of them.

Recent expansion of SME activity in the Vladivostok area (southern Primorski Krai) continues at an encouraging pace. Official statistics indicate that while economic output in Primorski Krai in 2001 declined slightly from 2000, but it has regained momentum and is growing again in 2002. Growth in disposable income provides a driving force for SMEs.

Recent reforms at the federal level and recent changes in political leadership at the Krai and the City level may prove positive for SME growth. Both the Krai government and the

City Administration state that SME growth is a priority and have policies, plans and programs in support of SMEs. The city maintains that 70% of its procurements are through SMEs. There are a number of larger associations representing specific industries as well as general associations that advocate business interests. It is not clear how effective they are in impacting public policy.

Obstacles to SME growth

Entrepreneurs, NGO leaders, bankers and government officials agree that SME access to affordable credit under reasonable terms remains the major obstacle to SME development in the region. This is true in spite of the presence of several alternative sources of credit for SMEs including the EBRD program, DeltaLease-FE, new credit unions and regular – but limited - bank loans. Further, DeltaLease-FE stated that it competes with six other leasing programs in the Vladivostok area. Another obstacle noted consistently is the high cost of energy and transportation. (See Section IV.I. Physical Infrastructure.) While the need for training was noted, several interviewees expressed the view that the challenge could be met through the many existing institutions and that new capabilities were not required.

Opportunities

Aside, perhaps, from taking steps to increase the availability of credit, USAID intervention to foster SME growth in Vladivostok would not appear to be necessary. The prospects for economic growth and for SME development in the Vladivostok area are quite positive. The following factors were consistently noted by interviewees and in relevant literature:

- Improved relations with China will result in expanded trade.
- Personal and family disposable income continues to drive growth.
- Apartment remodeling and building upgrading is expanding.
- General infrastructure improvements have received increased funding, notably for roads, housing and utilities.
- Opportunities for higher education are abundant.
- Wood processing enterprises are increasing at the expense of log exporting.
- Should it be realized, the Trans-Korean Railway will foster economic expansion.

F. Yakutsk

Background

The Republic of Sakha (Yakutia) is the largest administrative territory in the Russian Federation. It stretches 2,500 km from north to south and 2,000 km from east to west covering a territory equaling two-thirds of Western Europe. Forty percent of Yakutia's territory is above the Arctic Circle -- and very cold; most of the year it is a frozen desert.

The total population of the republic amounts to roughly one million people. About 640,000 people live in the cities and 360,000 in rural areas. The largest city, Yakutsk, has about 191,000 inhabitants. The assessment team was told that the population is slowly decreasing, as Yakuts leave for other parts of Russia.

Yakutia is nicknamed the “diamond box” of Russia, diamond mining being the major industry. The production of diamonds in the first nine months of 2002 fell by almost 1%, which was quite notable. Due largely to this fact, the growth rate in gross regional product declined from 4.2% to 2.4%. Oil, gas, gold and tin extracting sectors are other important industries. According to Goskomstat of Yakutiya, the Republic had slightly over 2,000 SMEs in 2002. (As explained in Section II, Goskomstat figures are likely to grossly understate the real number of SMEs.) Thirty-six percent of SMEs are concentrated in trade and the public catering sector; about 20% are engaged in construction, and 11% in agriculture and industry. The majority of SMEs are located in the city of Yakutsk (47%). The city of Nerungri has 15%, Mirninsky Ulus (district) — 9.2%, and Aldansky Ulus — 5.2%. All other territories account for 24% of SMEs.

In the first half of 2002 SMEs in Yakutiya produced goods and services worth of Rb2.3bn (\$73 million). This is 4.3% of the total production of the Russian Republic and it rose in the last year (3.4% in the comparable period of 2001).

The Yakutiya government is highly involved in the life of SMEs. For example, the government is taking considerable responsibility for extending credit and is now creating an institution to train businesspeople. The Minister of Economy has an advisory council of leading business leaders, which is both a means of allowing business to shape public policy and of keeping close tabs on the business community. Several of the SMEs with which the team met had government participation in ownership.

Obstacles

Physical Isolation. Yakutsk, in fact, is a rather small city in a frozen desert. The transportation is by air (expensive, infrequent and, due to weather problems, often unreliable). Shipping on the region’s major rivers is only possible in the summer. Rail service does not yet reach Yakutsk but is under construction. Rail service is likely to have a very significant effect, although rising tariffs for fuel and electricity may partially offset the potential economic gain. The internal market for consumer goods is limited both by the region’s small population and by the large income disparities that exist between the traditional rural population and those who are prospering from the diamond, oil, gas and tin industries.

Lack of Credit. SMEs in Yakutiya have difficulty obtaining credit. According to the Yakutian Ministry of Entrepreneurship, the bulk of lending for SMEs comes not through the banking sector, but via a special government fund for support of small businesses. The fund reportedly has 30 branch offices. In the 2000-2001 fiscal year the fund allocated Rb. 90 million (\$2.9 million) through 520 credits. The Ministry claims that, as a result, 1,760 jobs were created.

Excessive inspections. Several members of the local business community were forthright in criticizing government authorities for various deficiencies, particularly excessive inspections. These check-ups can seriously impede the development of new entities or kill matured ones. One businessman described his relationship with the governmental authorities openly used the expression “we behave, we share,” an apparent euphemism

for corruption. Transparency has quite obviously not yet been achieved in the relationships between government and business.

Opportunities

As noted above, government authorities see a need to increase business training and have initiated a program of short courses on selected topics. The ARC program envisions Yakutsk as one of five “satellite centers” for its program and apparently has agreed to provide training of trainers courses (in Anchorage) to teachers at the government’s new “business school.” It was unclear what other collaborative activities the ARC program and the business school might be contemplating.

IT Development. In the information technologies sector, an estimated 85% of the total output in monetary terms belongs to SMEs. These new businesses, often formed by young, energetic and well-educated people, exhibit tremendous dynamism and growth potential. They can serve a variety of clients from small retail to rather large plants.

The construction business remains a promising sphere for SMEs. The team observed a good deal of construction in Yakutsk, and was told that there is considerable demand for well-insulated individual residences to serve the scattered population. SMEs find themselves quite competitive in this sector.

Traditional businesses such as fur garment sewing could theoretically expand their sales, but are constrained by transportation tariffs and lack of marketing.

The *souvenir business* does well in terms of employment but has quickly reached the market saturation point.

G. Yuzhno-Sakhalinsk

Background

Sakhalin, an island about the size of Florida, is located in the Sea of Okhotsk off the east coast of Khabarovsk Krai and just north of the Japanese Island of Hokkaido. The population of the Island is about 600,000 with 165,000 in Yuzho-Sakhalinsk, the capital city of Sakhalinskaya Oblast.

Sakhalin is enjoying an economic boom as a result of the development of the oil and gas deposits located just off its eastern coast. The impact derived from the investment in production facilities and from the actual production from these deposits will be the defining economic force in Yuzhno-Sakhalinsk and the Sakhalinski Oblast for the foreseeable future. The U. S. Department of Commerce predicts that investment in the Sakhalin oil and gas industry may exceed U.S.\$1 billion in 2002.

There are a variety of USG-assisted programs operating on Sakhalin, many of which foster the growth of SMEs. Among these are the ACDI/VOCA micro-credit program, the Russian-American Business Training Center, the American Business Center, FRAEC, the Eurasia Foundation, the FOREST Project and Junior Achievement.

Obstacles to SME growth

SMEs on Sakhalin have faced problems similar to small businesses throughout Russia. These include a banking system unresponsive to their needs and government policies and regulations that made it difficult to do business. At the present time, SMEs face the additional challenge that the attention of public sector officials is largely focused on the developments in the oil and gas industry. However, despite the attention being paid to oil and gas, the Federal Anti-monopoly Ministry, the Oblast Government and the Yuzhno-Sakhalinsk City Administration have each created programs and plans to foster SME growth. The current funding of these programs is limited, however, and the small and medium-sized business community remains skeptical.

Currently there are only a few small and specialized business associations on Sakhalin. It is not clear that these associations can effectively capture the attention of key government leaders, particularly in this extraordinary period of large-scale oil and gas investment.

Opportunities

SME growth on Sakhalin will result indirectly from the oil and gas development. The very large investment programs underway will create new jobs and result in significant growth in disposable income, a substantial share of which will be directed toward consumer goods and services provided by Sakhalin's SMEs in the trade and service sectors. The hospitality industry will grow along with tourism, housing and infrastructure.

With respect to current and future USAID programs in Yuzhno-Sakhalinsk, the assessment team believes that the ACDI/VOCA microcredit program is filling an important gap in the credit system and that the Junior Achievement is a sound investment in the long-term growth of the market economy of the region. Additional investment in these programs, resources permitting, would yield high results.

The Russian-American Business Training Center, an arm of the American Russian Center of the University of Alaska at Anchorage (UAA) is partnered with Sakhalin State University to provide business training programs. The July 2000 evaluation of USAID-assisted business training programs found that the ARC programs have high impact, and local businesspeople and officials with whom the assessment team met confirmed that the ARC programs are valued. Yet, as noted above, the ARC program is still managed from Anchorage and is not sustainable as a Russian entity. With the oil boom beginning, it is clearly a propitious moment for the ARC to secure local financing to become self-sufficient. Failure to achieve self-sufficiency in the emerging conditions would signify a serious lack of local support for the program.

The assessment team believes that it would be valuable to expand the availability of business training to other cities. However, the team does not believe that it can recommend the expansion of a mature program that has not demonstrated that the local community can sustain it. USAID should consider such a program expansion only if the prospects for financial sustainability are high.